Supreme Court, U.S.
FILED

981736 APR 29 1999

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No. _____

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1999

DONALD M. ROWE,

Petitioner,

v.

MARIETTA CORPORATION, and
JOHN S. NADOLSKI,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

In light of the over 500 reported cases which have applied the concept of "loss causation"[1] in the securities fraud context, the academic and judicial recognition of widespread confusion concerning that concept among the Circuits, and the Supreme Court's silence on the subject, should the Sixth Circuit be allowed to add to the existing confused state of the law by holding, in conflict with decisions of other Circuits, that loss causation is not established even though: securities fraud was committed by misrepresentation of investment risk in face-to-face negotiations, the misrepresentation induced the victim to assume a risk he would have otherwise shunned, the parties were in privity, and the loss suffered was due to the materialization of the risk which was misrepresented.

In light of the policy of the securities law to deter securities fraud, should misapplication of the concept of "loss causation" be allowed to produce a judicial ratification of the felonious taking and retention of a $3.7 million profit by a company whose president was criminally convicted of the fraud in question?

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[1]Since the concept of "loss causation" is now in use in securities fraud litigation in all circuits, it may safely be said that it is a consideration in every securities fraud case or controversy involving damages. Thus the impact of the doctrine is potentially on thousands of disputes.

LIST OF PARTIES TO THE PROCEEDINGS IN THE COURT BELOW

Petitioner

Donald M. Rowe

Respondents

Marietta Corporation and John S. Nadolski. The corporation has no parent company or non-wholly owned subsidiaries.

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OPINIONS BELOW

The Opinion of the United States Court of Appeals for the Sixth Circuit is included in the Appendix at Appendix A at 1a. The Opinion of the District Court for the Western District of Tennessee is included in Appendix B at 22a. The District Court ordered entry of the final judgment on June 6, 1997. It is printed in Appendix D at 119a.

JURISDICTION

The United States Court of Appeals for the Sixth Circuit issued its Opinion on January 6, 1999. On January 19, 1999, Petitioners filed a Petition for Rehearing and Suggestion for Rehearing *En Banc* which the United States Court of Appeals denied on February 9, 1999 (Appendix C at 117a). This Petition for Writ of Certiorari is filed within 90 days of the denial of the Petition for Rehearing. The Court's jurisdiction is invoked pursuant to 28 U.S.C. §§1254(1) and 2106.

CONSTITUTIONAL PROVISIONS, TREATIES, STATUTES, RULES AND REGULATIONS INVOLVED

15 U.S.C. §78j(b):

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or

instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

15 U.S.C. §78t(a):

"Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

17 C.F.R. §240.10b-5:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of

the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

STATEMENT OF THE CASE

In 1987, the Defendant Marietta Corporation, then a publicly held company, and its President, Defendant John Nadolski, attempted to induce Plaintiff Donald M. Rowe to sell his stock representing a 90% interest in American Soap Company on terms which included a promise to share with Rowe a portion of the companies' combined future profits over a five year period (the "earnout"). Rowe declined because Marietta's lack of a business record made the earnout too risky. Between 1987 and 1989, Defendants falsified Marietta's financial reports for three fiscal years in order to make it appear that Marietta was an extremely fast growing and profitable company. In 1989 Defendants again approached Rowe. This time, Rowe agreed to sell and did sell on terms that included the earnout. In truth, however, Marietta was not the fast growing and profitable company represented,[2] and during the five-year period following Rowe's sale to Marietta, the earnout failed to produce the

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[2]"[Defendant John] Nadolski [President of Marietta Corporation] was tried and criminally convicted . . . of four violations of federal securities laws . . ." (District Court Opinion, Appx. p. 31a). "Thomas Blair . . . the Secretary-Treasurer, Chief Financial Officer, and a director of Marietta from 1987 until 1991 . . . admitted to embezzl[ement] and pled guilty to illegally moving [money] in interstate commerce . . . and to conspiring to commit perjury . . ." (District Court Opinion, Appx. p. 30a).

expected profit. Rowe's 90% interest in American Soap was worth $13,654,008, but, because the earnout failed, Rowe was paid only $9,941,044. Notwithstanding Rowe's loss and the Defendants' gain by the difference, $3,712,964, the Sixth Circuit denied Rowe relief on the ground that he had failed to prove "loss causation."

The District Court had original jurisdiction pursuant to 15 U.S.C. §78aa, and 28 U.S.C. §1331.

The facts are stated in the words of the Sixth Circuit and the District Court as follows:

> "Several negotiations had occurred prior to the 1989 sale. In 1987, [Defendant] Marietta proposed a purchase deal that included a substantial amount of Marietta stock and an "earnout" provision. The earnout provision required that Rowe accept, as partial consideration for the sale of his business, a percentage of the profits of the merged corporation over a period of years. The provision's structure, however, granted Rowe only a percentage of the profits above certain earnings thresholds, set higher for each succeeding year. If the merged corporation's earnings failed to meet that threshold, Rowe would receive nothing from

the provision. Thus, the earnout provision entitled Rowe to the conditional right to a percentage of profits, with the risk factor that the outcome was contingent upon the merged corporation's success in the marketplace.

Rowe declined to sell in 1987 because Marietta had no real business record. Rowe lacked confidence that the risk in accepting such consideration was worthwhile. As Marietta's reports began showing increased earnings, Rowe's confidence also increased. Marietta presented increases in net sales between 1986 and 1987 of 33.37 percent and 53.5 percent between 1987 and 1988; it also represented that profitability had grown by 42.41 percent between 1986 and 1987 and 36.61 percent between 1987 and 1988. However, these representations were false. Over three years, Marietta overstated its net income by $1.7 million, or 37 percent." (Sixth Circuit Decision, Appx. p. 3a.)

"[Marietta's President] Nadolski and [Marietta's Treasurer] Blair caused the creation of $1,000,000 in fraudulent sales for the quarter [ending just prior to the March 10, 1989 transaction with Rowe] . . . Had

Marietta not overstated sales by $1,000,000, the company would have posted a $297,000 net loss for the quarter. Additionally, based on the $1,000,000 fraudulent inflation of its sales for the first quarter of fiscal 1989, Marietta posted earnings per share for that quarter of $0.23. Marietta's real sales for the first quarter of fiscal 1989 would have generated an actual loss of $0.14 per share." (District Court Decision, Appx. p.35a.)

"Despite having refused to sell on the 1987 terms, Rowe accepted very similar terms in 1989 after Marietta's [fraudulently inflated] profit figures added confidence that the risk was attractive. As consideration for Rowe's 90% stock of ASC, Rowe received five components . . . [Component 4 was the] right to contingent payments under the 'earnout,' based on one-half of all ASC's glycerine net earnings, and one-half of all soap business profits of ASC and Marietta before interest and taxes over fixed thresholds; . . ." (Sixth Circuit Decision, Appx. pp. 3a-4a)

"Rowe's loss resulted from the failure of Marietta to earn beyond the thresholds

established under the earnout clause." (Sixth Circuit Decision, Appx. p. 14a)

The value of Rowe's 90% interest in American Soap Company was $13,654,008 (Sixth Circuit Decision, Appx. p. 8a).

There were five (5) components of consideration to be paid to Rowe. The value paid by Defendants pursuant to components 1, 2, 3 and 5 totaled $9,871,168.[3] (Sixth Circuit Decision, Appx. pp. 3a-4a). The only amount paid by the Defendants under component 4, the earnout, was $69,876 (Sixth Circuit Decision, Appx. p. 12a). Therefore, the total paid by Defendant-fraud-feasors to Rowe for his 90% interest in American Soap Company was $9,941,044.

The value received by the Defendant fraudfeasors and given up by Rowe (90% share of American Soap Company) was $13,654,008. The amount the fraudfeasors paid Rowe was $9,941,044. The difference was $3,712,964. The Sixth Circuit's decision rewards the Defendants' fraud by that amount, $3,712,964, plus interest, and deprives

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[3] 1. $4,827,310 unallocated cash
2. $1,350,000 cash for non-compete agreement
3. $1,884,716 present value of note
5. $1,809,142 value of Marietta shares
$9,871,168 (Sixth Circuit Decision, Appx. pp. 4a, 8a)

Rowe of that amount. Rowe was not returned to the *status quo ante*.

The Defendants were allowed to profit from their fraud despite the fact that the risk which was misrepresented was the same risk that materialized. The Sixth Circuit held that "loss causation" had not been established under these facts.

ARGUMENT FOR GRANTING THE WRIT

There are over five hundred reported case law references in the Westlaw federal securities law database to the concept of "loss causation." The judicial formulations and applications of this concept vary widely. See, e.g., Kaufman, *Loss Causation: Exposing A Fraud on Securities Law Jurisprudence*, 24 IND. L. REV. 357 (1991); Fisher, *The Analyst - Added Premium in Open Market Securities Fraud Cases*, 52 BUS. LAWYER 35, at 52-54 (1997).[4] Judge

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[4]"Many . . . decisions recognize that 'loss causation' is an element of a Rule 10b-5 case. [McGonigle v. Combs, 968 F.2d 810, 820 (9th Cir. 1992); Arthur Young & Co. v. Reves, 937 F.2d 1310, 1327-28 (8th Cir. 1991); Bruschi v. Brown, 876 F. 2d 1526, 1530-31 (11th Cir. 1989); Harris v. Union Elec. Co., 787 F.2d 355, 367 (8th Cir. 1986)] Articulations of this element differ. Some courts call the requirement one of 'proximate cause,' asserting that the

(continued...)

Posner has questioned whether the term "loss causation" advances understanding at all. Bastian v. Petren Resources Corp., 892 F.2d 680, 685-86 (7th Cir. 1990). "There remains substantial disagreement, both implicit and explicit, among the Circuits as to the proper approach to securities causation," Steckman and Conner, *Loss Causation Under Rule 10b-5, A Circuit-By-Circuit Analysis: When Should Representational Misconduct Be Deemed the Cause of Legal Injury Under the Federal Securities Laws?* 1061 PLI/Corp 375, 504 (1998). See generally, Georgakopoulos, *Frauds, Markets, & Fraud-On-The-Market: The Tortured Transition of Justifiable Reliance From Deceit to Securities Fraud*, 49 U. Miami L. Rev. 671 (1995) (noting substantial confusion in the case law).

(...continued)
misrepresentation or omission must 'touch . . . upon the reasons for the investment's decline in value.' [Huddleston v. Herman & MacLean, 640 F. 2d 534, 554-55 (5th Cir. 1981)] Other courts refer to the 'nexus between the defendant's fraudulent conduct and the plaintiff's pecuniary loss,' [Harris v. Union Elec. Co., 787 F. 2d 355, 367 (8th Cir. 1986)] while still others explain loss causation to mean that 'the damage complained of [was] a foreseeable result of the plaintiff's reliance on the fraudulent misrepresentation.' [Weiss v. Wittcoff, 966 F. 2d 109, 111 (2d Cir. 1992); Klein v. Boyd, {1996-1997 Transfer Binder} Fed. Sec. L. Rep. (CCH) P. 99,352, at 96,176 (E.D. Pa. Nov. 18, 1996). Fisher, *id* at 52.

Judge Easterbrook has called the terms "loss causation" and "transaction causation" "confusing in practice because they do not link the definition of 'causation' to any theory about why people might be liable under the securities laws." LHLC Corp. v. Cluett, Peabody & Co., Inc., 842 F. 2d 928, 931 (7th Cir. 1988), cert. denied, 488 U.S. 926 (1988). Judge Frankel, while he thought that the labels "may prove eventually to be useful," was "not convinced at this time that the Circuit ought to be committed to their employment or to their still uncertain implications." Schlick v. Penn-Dixie Cement Corp., 507 F. 2d 374, 384 (2d Cir., concurring opinion), cert denied, 421 U.S. 976 (1974).

Notwithstanding these judicial reservations, there is now widespread use of the concept in securities fraud cases. Despite the "substantial disagreement" among the Circuits, the Supreme Court has never provided guidance as to the proper application and meaning of the loss causation concept.

The Sixth Circuit's instant decision puts that Circuit in conflict with numerous other Circuits, adding to the confusion in the case law. Furthermore, this Court has repeatedly noted that the intent of the securities laws is to deter fraud. Randall v. Loftsgaarden, 478 U.S. 647, 664, 106 S. Ct. 3143, 92 L. Ed. 2d 525 (1986); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151, 155,

92 S. Ct. 1456, 31 L. Ed. 2d 741 (1972); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 US 6, 12 (1971). In direct contradiction of the statutory intent to deter securities fraud, the Sixth Circuit's misapplication of the concept of loss causation has made it a shield for fraud, allowing the defendant fraudfeasors to profit by $3.7 million, even though Defendant Nadolski, President of Defendant Marietta, was criminally convicted for the same fraud.

The Sixth Circuit held that even though Mr. Rowe was in direct privity with the Defendants and was the victim in face-to-face negotiations of fraudulent misrepresentations which induced him to enter into a transaction he would otherwise shun because of the risk, and even though his loss resulted from the materialization of the same risk that was misrepresented, he failed to prove "loss causation." In so holding, the Sixth Circuit decision is in conflict with decisions of the Second, Fifth, Seventh, Eighth, Ninth and Eleventh Circuits. Those Circuits hold that where securities fraud induces a party to enter into a transaction he would otherwise avoid because of its riskiness -- and the loss results because the risk misrepresented materializes, and/or where there is fraudulent inducement in a transaction involving privity, that "loss causation" is established.

The cases which conflict with the Sixth Circuit's decision include Bastian v. Petren Resources Corp., 892 F. 2d 680, 685-86 (7th Cir. 1990); Bruschi v. Brown, 876 F. 2d 1526, 1530-31 (11th Cir. 1989); Marbury Management, Inc. v. Kohn, 629 F. 2d 705, 708 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); Chasins v. Smith, Barney & Co., Inc., 438 F. 2d 1167, 1173 (2d Cir. 1970); Huddleston v. Herman & MacLean, 640 F. 2d 534, 554-55 (5th Cir. 1981); In Re: Letterman Brothers Energy Securities Litigation, 799 F. 2d 967, 972 (5th Cir. 1986); Garnatz v. Stifel, Nicholas & Co., Inc., 559 F.2d 1357, 1360 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978); Harris v. Union Electric Co., 787 F. 2d 355 (8th Cir. 1986), *cert. denied*, 479 U.S. 823 (1986); In re: Control Data Corp. Securities Litigation, 933 F. 2d 616, at 618-621 (8th Cir.), *cert. denied*, sub nom., 502 U.S. 967 (1991); Arthur Young & Co. v. Reves, 937 F. 2d 1310, 1332 (8th Cir. 1991), aff'd sub nom., 507 U.S. 107; and Hatrock v. Edward D. Jones & Co., 750 F. 2d 767, 773 (9th Cir. 1984).

The purpose of the "loss causation" rules is to prevent recovery of damages in suits based on misstatements in securities offerings which did not actually cause harm. A decision for Rowe in this case would be consistent with that purpose. In Rowe's case, there was a fraudulent inducement by misrepresentation of the risk involved, and the loss resulted from suffering the consequences of the same risk which was misrepresented: "Despite having refused to sell

on the 1987 terms, Rowe accepted very similar terms in 1989 after Marietta's [fraudulent] profit figures added confidence that the risk was attractive." (Sixth Circuit Decision, Appx. pp. 3a-4a). "Rowe's loss resulted from the failure of Marietta to earn beyond the thresholds established under the earnout clause." (Sixth Circuit Decision, Appx. p. 14a)

This case is a particularly fine vehicle for resolving the existing conflicts among the Circuits. Because the fraud in this case was perpetuated in face-to-face negotiations, there was direct reliance, privity, and the investment risk misrepresented was the same risk that materialized,[5] there is no danger that resolution of this case in Rowe's favor will open a Pandora's box of strike suits. This case fits the example given in Judge Posner's carefully crafted opinion in Bastian v. Petren Resources Corp, 892 F. 2d 680, 685-86 (7th Cir. 1990).

Judge Posner's opinion in Bastian is considered one of the leading decisions on "loss causation." Bastian makes

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[5]Although neither the District Court nor the Sixth Circuit accepted Defendants' claim of waiver (obviously neither would have reached the loss causation issue if they had), since it is mentioned in the Sixth Circuit opinion an explanation and the record citations showing there was no waiver are provided in Appendix F, p. 124a, *et seq.*

it clear that where, as here, the risk misrepresented is the risk which materialized, loss causation is established. In that case, Judge Posner reasoned that a securities fraud plaintiff should have to show that the loss suffered was a result of the fraud perpetrated. Losses attributed to external forces unrelated to the risk misrepresented would not be recoverable. In conflict with the Sixth Circuit, Bastian recognized that recovery is proper when an investor was fraudulently induced to take a risk, and the risk misrepresented was the risk that materialized:

> "Suppose a broker gives false assurances to his customer that an investment is risk-free. In fact it is risky, the risk materializes, the investment is lost. Here there can be no presumption that but for the misrepresentation the customer would have made an equally risky investment. On the contrary, the fact that the broker assured the customer that the investment was free of risk suggests that the customer was looking for a safe investment. Liability in such a case . . . is therefore consistent with nonliability in a case such as the present." 892 F. 2d at 685-86.

The Eleventh Circuit's decision in Bruschi v. Brown, 876 F.2d 1526 (11th Cir. 1989) is also among those which conflict with that of the Sixth Circuit. It involved fraudulent inducement to purchase securities. An investment advisor

recommended purchase of securities that were unsuitably risky for a client and in which he had an undisclosed financial interest. According to the Eleventh Circuit, loss causation is established when "a defendant induces a plaintiff to enter into a risky transaction by misrepresenting it as safe and the plaintiff suffers a loss resulting from the risky nature of the investment." *id.* at 1531. This is precisely what happened in this case. Defendants misrepresented fundamental elements of Marietta's performance, to-wit: they falsely portrayed Marietta as a fast growing company with an outstanding record of spectacularly increasing profits. That went to the heart of the earnout which was based on the future profits of the combined company. In such a circumstance -- where plaintiff assumes a substantially riskier investment than he agreed to undertake, and the loss results from the materialization of that risk -- plaintiff satisfies the causation requirement and is entitled to recover damages to make him whole.

The Sixth Circuit's opinion also conflicts with the Second Circuit decision in Marbury Management, Inc. v. Kohn, 629 F. 2d 705 (2d Cir. 1980). In Marbury, a trainee at a brokerage firm fraudulently misrepresented himself as a "lawfully licensed registered representative." An investor acted in reliance on the trainee's advice, believing that advice to have been provided by an experienced broker. The Second Circuit held that the trainee's fraudulent

misrepresentation was the "legal cause of the loss" for which the investor should be allowed recovery. *Id.* at 708. Investors who rely on the experience of a broker but are defrauded because that broker is merely a trainee are taking a much greater risk than they thought and are entitled to recover damages for their loss.

In Garnatz v. Stifel, Nicholas & Co., Inc., 559 F.2d 1357, 1360 (8th Cir. 1977), cert. denied, 435 U.S. 951 (1978), the Eighth Circuit also recognized that the proper measure of damages in a case involving misrepresentations of the degree of risk is the rescissory damage measure which "seeks to return the parties to the *status quo ante* the sale."

The above cases have been acknowledged by distinguished commentators to embody correct application of loss causation principles. The commentators have noted that where an investor has been induced, through representational misconduct, to accept unwanted risk, reliance on misrepresentations or material omissions should constitute a sufficient causal link between the misrepresentation and legal loss:

> "If the plaintiff would not have purchased the stock, had the truth been known, then a court should not charge her with any losses from the investment. Under these circumstances the fraud induced the plaintiff to accept risks

> that she would not have chosen otherwise. . . . If a fraudulently overstated prospect of gain, or a fraudulently understated risk of loss, convinces an investor to accept the total risk-return prospect offered by the investment as a whole, then that misrepresentation has induced the plaintiff to undertake the disclosed risks posed by the investment. The courts should permit the plaintiff to recover for any loss in value resulting from the occurrence of risks that she would not have accepted willingly had the misrepresentation not altered her evaluation of the total risk package." Merritt. *A Consistent Model for Loss Causation in Securities Fraud Litigation: Suiting the Remedy to the Wrong*, 66 Tex. L. Rev. 469, at 522-23 (1988).

See also Easterbrook & Fischel, *Optimal Damages in Securities Cases,* 52 U. CHI. L. REV. 611, 648-51 (1985).

Many of these cases have arisen in situations where a broker has misrepresented the degree of risk. However, it has been pointed out that the broker cases do not constitute an exception to general securities causation jurisprudence. Kaufman, *Loss Causation: Exposing a Fraud on Securities Law Jurisprudence*, 24 IND. L. REV. 357, 389-90 (1991)

(explaining Garnatz v. Stifel, Nicolas & Co, 559 F. 2d 1357 (8th Cir. 1977) on the grounds that the misrepresentations were "so material" as to cause plaintiff to part with the purchase price of the securities, not because the case dealt with broker dealers).

Bruschi, Bastian, Marbury and Garnatz are all consistent with the common law recognition that a substantial increase in the risk that a foreseeable event would occur is sufficient to establish proximate cause. See *Restatement of the Law, Second*, Torts 2d §281, Comm. e. See also *Restatement of the Law, Second*, Torts, §448 B, Comment b:

> "If the actor's conduct has created or increased the risk that a particular harm to the plaintiff will occur, and has been a substantial factor in causing that harm, it is immaterial to the actor's liability that the harm is brought about in a manner which no one in his position could possibly have been expected to foresee or anticipate. This is true not only where the result is produced by the direct operation of the actor's conduct upon conditions or circumstances existing at the time, but also where it is brought about through the intervention of other forces which the actor could not have expected,

> whether they be forces of nature, or the actions of animals, or those of third persons which are not intentionally tortious or criminal."

Rowe proved that by misrepresentations which increased the risk of loss from the earnout he was fraudulently induced to accept a risk that he would have otherwise have not accepted, and that the loss resulted from the materialization of that very risk. However, contrary to the above decisions and authorities, the Sixth Circuit imposed on Rowe the burden of proving 'something more' to establish "loss causation."

The Sixth Circuit does not define what more Rowe would have had to prove. Indeed, in a real world context, there was nothing more Rowe could have proven. Was Rowe required to prove that, had he known the truth, the earnout would have been negotiated to contain different terms, such as lower thresholds, and that under a different agreement, he would have earned more than the $69,876? Clearly imposing such a burden on Rowe is inconsistent with the finding that Rowe would not have entered into the transaction at all had he been told the truth.

Marietta's President, John Nadolski, and its Treasurer, Thomas Blair, were both found guilty of criminal conduct. Marietta's profits and earnings were found to have

been fraudulently inflated, and materially so. Was Rowe required to prove that if the company had actually had the spectacular growth in sales and profits that had been represented, and if it been actually been managed by two truly able top executives, that the earnout would have produced a better return? Such speculative matters are not to be imposed as an additional burden on the innocent victim. As Professor Hazen has pointed out:

> "It is absurd to place the burden of proof of such speculative matters on the injured party as opposed to the wrongdoer. There is ample support for requiring that in a fraudulent inducement case, once the plaintiff establishes that there was transaction causation, the burden shifts to the defendant that the loss was due to wholly independent factors."Hazen, *Treatise On The Law of Securities Regulation*, Vol. 2 at 545 (3d ed. 1995).

Professor Hazen also states, consistently with the cases cited above, that "[i]n an inducement situation -- where the misrepresentation or omission induced the challenged transaction -- it is sufficient to show that plaintiff's loss was caused by the transaction." Hazen, *Treatise On The Law of Securities Regulation*, Vol. 2 at 545 (3d ed. 1995).

Many varying approaches have been adopted by the Circuits in applying the concept of "loss causation" in the securities fraud context. Some cases have noted that where privity is involved the proper remedy for fraudulent inducement is that the victim be returned to the *status quo ante*. See Chasins v. Smith, Barney & Co., 438 F2d 1167, 1173 (2d Cir. 1970). See also In re: Letterman Securities Litigation, 799 F. 2d 967, 972 (5th Cir. 1986) and Huddleston v. Herman & MacLean, 640 F. 2d 534, 555 (5th Cir. 1981), aff'd in part and rev'd in part on other grounds, 459 U.S. 375 (1983), making the "privity" distinction. As this case illustrates, where there is a face-to-face fraudulent inducement, privity, there is an increased likelihood that the party committing the fraud may directly benefit from it. Here the Defendants made a $3.7 million profit as a direct result of the commission of a felony.

Chasins v. Smith, Barney & Co., 438 F. 2d 1167, 1173 (2d Cir. 1970) held that the requirement of proof of "loss causation" is met where there was a special relationship between buyer and seller such as privity and "there was a failure to disclose material information about the underlying investment." The Rowe case meets both requirements. In Chasins, the defendant broker claimed that plaintiff was not entitled to recovery because, despite the fraud, plaintiff suffered no injury. That is, the defendant asserted that there was no loss causation since plaintiff paid the same price to defendant that he would have paid to

another broker. The Court of Appeals rejected that argument because the issue did not involve defendant's alleged manipulation of price. Rather, the impact of defendant's fraud was to induce plaintiff to enter into a transaction that plaintiff would not have entered into. In such a situation, the elements of causation are satisfied, and the remedy is to make plaintiff whole. See also Manufacturers Hanover Trust Co. v. Drysdale Securities Corp., 801 F. 2d 13 (2d Cir. 1986).

Huddleston, *supra*, is cited and relied on by the Sixth Circuit (Sixth Circuit Decision, p. 13a), however, the Sixth Circuit misapplied Huddleston. As Letterman, *supra*, explains, discussing Huddleston, the Fifth Circuit applies the Chasins approach in cases, such as Rowe's, involving privity:

> "The district court used the out-of-pocket measure of damages set out in Huddleston v. Herman & MacLean, 640 F. 2d 534, 555 (5th Cir. 1981), aff'd in part and rev'd in part on other grounds, 459 U.S. 375, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983). Under Huddleston, in a Rule 10b-5 action a purchaser of securities may recover against a defendant *with whom the purchaser was not in privity* or who owed the purchaser no fiduciary duty only the 'difference between the price paid and the "real" value of the security . . . at the time of the initial

> purchase by the defrauded buyer.' Id. at 556. *** Huddleston indeed explicitly reserves the Chasins recissional measure of damages *for cases in which the purchaser and defendant are in privity* or in which the defendant owes some fiduciary duty to the purchaser. Id. at 554. In Chasins, the plaintiff had been lured into purchasing securities on the basis of misrepresentations made by a broker." (Emphasis added) 799 F. 2d at 972.

The Sixth Circuit's decision in Rowe also conflicts with the "some causal nexus" test of the Eighth Circuit. Harris v. Union Electric Co., 787 F. 2d 355 (8th Cir. 1986), *cert. denied*, 479 U.S. 823 (1986); In re: Control Data Corp. Securities Litigation, 933 F. 2d 616, at 618-621, *cert. denied*, sub nom., 502 U.S. 967 (1991); Arthur Young & Co. v. Reves, 937 F. 2d 1310, 1332 (8th Cir. 1991), aff'd sub nom., 507 U.S. 107. In addition, it conflicts with the Ninth Circuit's decision in Hatrock v. Edward D. Jones & Co., 750 F. 2d 767, 773 (9th Cir. 1984) that a plaintiff "should not have to prove loss causation where the evil is not the price the investor paid for a security, but the [defendant's] fraudulent inducement of the investor to purchase the security."

The Sixth Circuit's decision also conflicts with American Law Institute's Federal Securities Code which defines causation in these terms:

"A loss is 'caused' by specified conduct to the extent that (A) the conduct was a substantial factor in producing the loss, and (B) the loss was of a kind that might reasonably have been expected to occur as a result of the conduct." 1 American L. Inst., *Federal Securities Code* 56-63 (1980), Comments to §202(19).

The commentary has this to say:

"§202(19)(A): This is the language of 'causation in fact' that Restatement (Second) of Torts, §546 uses in stating the general rule on causation and deceit. As applied to the *fact* of causation alone, according to Prosser, no better test has been devised. Prosser, Torts, 240, 248 (4th Ed. 1971). The language makes it plain, for example, that if the defendant's misrepresentation was a 'substantial factor' in inducing the plaintiff to buy, the defendant is not absolved merely because other factors -- for example, the plaintiff's having recently received a large inheritance or his having been counseled to diversify his portfolio -- contributed to this result.

> §202(19)(B): To repeat, it does not follow that 'but for' causation (as defined in 'substantial factor' terms) should always establish liability. For 'but for' is at most a rule of exclusion: if it is not satisfied, clearly there can be no causation, but, even if it *is* satisfied, policy considerations other than factual causation may preclude liability. See *id.* at 238-239. These are the considerations subsumed under the question-begging but useful term, 'legal cause,'which §202(19)(B) defines in the reasonably expectancy language of Restatement (Second) of Torts §548A -- a test that, realistically, must be reviewed as a general caveat that 'but for' is not necessarily enough."

The risk that an earnout, which was based on the combined earnings of Marietta and the acquired company, would fail to produce increased profits was within the foreseeable risk of harm to Rowe which was produced by materially misrepresenting Marietta's profitability for the three fiscal years preceding the transaction. The RESTATEMENT OF TORTS, 2d §584A states that loss causation is established where the pecuniary loss is within the foreseeable risk of harm created by the misrepresentation:

"§584A. Legal Causation of Pecuniary Loss
A fraudulent misrepresentation is a legal cause of a pecuniary loss resulting from action or inaction in reliance upon it if, but only if, the loss might reasonably be expected to result from the reliance.
Comment:

A. Causation, in relation to losses incurred by reason of a misrepresentation, is a matter of the recipient's reliance in fact upon the misrepresentation in taking some action or in refraining from it. (See §546). Not all losses that in fact result from the reliance are, however, legally caused by the representation. In general, the misrepresentation is a legal cause only of those pecuniary losses that are within the foreseeable risk of harm that it creates. There is an analogy here to the rules as to legal causation of physical harm resulting from negligent conduct, stated in §§435 to 461."

The Sixth Circuit's failure to correctly apply the concept of "loss causation" may be partially explained by the lack of clear guidance by the U.S. Supreme Court, which has never spoken on the issue, and by the many conflicting formulations of the concept in the case law. The instant decision departs from correctly reasoned decisions in

other Circuits. The Sixth Circuit's decision adds to the existing confusion concerning the proper application of the concept of "loss causation."

Furthermore, as applied by the Sixth Circuit the concept has become a shield for fraud. In cases such as this, involving privity and fraudulent inducement, there is an enhanced possibility that the fraudfeasor may have profited directly from the securities fraud. In violation of the unmistakable intent of the securities laws to deter fraud, a policy which this Court has repeatedly noted,[6] the decision below rewards the Defendants' felonious conduct with a $3.7 million profit. That was a $3.7 million profit that could not have been achieved permanently without the commission of fraud and the aid of a judicial misapplication of the doctrine of "loss causation."

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[6]Randall v. Loftsgaarden, 478 U.S. 647, 664, 106 S. Ct. 3143, 92 L. Ed. 2d 525 (1986) ("Congress intended to deter fraud and manipulative practices in the securities markets, and to ensure full disclosure of information material to investment decisions."); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151, 155, 92 S. Ct. 1456, 31 L. Ed. 2d 741 (1972); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 US 6, 12 (1971).

CONCLUSION

Bruschi,[7] Bastian,[8] Marbury,[9] Garnatz,[10] the RESTATEMENT OF TORTS, SECOND, the American Law Institute's *Federal Securities Code*, Professor Hazen, and the other cases and commentators cited herein, all teach that loss causation is demonstrated where, as here, there was a fraudulent misrepresentation of the risk of a foreseeable event, and the risk misrepresented was the risk that materialized.

The existing confusion in the case law should be cleared away. This is especially necessary in light of the hundreds of securities fraud cases which have attempted, with varying success, to apply the concept, and the thousands of securities fraud disputes that are and will be affected by the "loss causation" doctrine.

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[7] Bruschi v. Brown, 876 F. 2d 1526, 1530-31 (11th Cir. 1989).

[8] Bastian v. Petren Resources Corp, 892 F. 2d 680, 685-86 (7th Cir. 1990).

[9] Marbury Management, Inc. v. Kohn, 629 F. 2d 705, 708 (2d Cir.), cert. denied, 449 U.S. 1011 (1980).

[10] Garnatz v. Stifel, Nicholas & Co., 559 F. 2d 1457, 1360-1361 (8th Cir. 1997), *cert denied* 435 U.S. 951.

Certiorari should be granted both to clarify the widely used concept of "loss causation," and to resolve the differences among the Circuits.

Respectfully submitted,

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Supreme Court, U.S.
FILED

981736 APR 29 1999

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No. _____

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1999

DONALD M. ROWE,

Petitioner,

v.

MARIETTA CORPORATION, and
JOHN S. NADOLSKI,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

APPENDIX TO PETITION FOR WRIT OF CERTIORARI

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APPENDIX A

Opinion of the United States Court of Appeals for the Sixth Circuit

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NOT RECOMMENDED FOR FULL-TEXT PUBLICATION

NO. 97-5789 / 5791 / 5892

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

FILED

JANUARY 6, 1999

DONALD M. ROWE

Plaintiff - Appellant/Cross-Appellee,

V.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF TENNESSEE

MARIETTA CORPORATION;
JOHN S. NADOLSKI

Defendants - Appellees/Cross-Appellants.

BEFORE: **BOGGS, SUHRHEINRICH and SILER, Circuit Judges.**

PER CURIAM. This case involves an award of damages from Marietta Corporation's fraudulently induced purchase of Donald M. Rowe's 90 percent interest in American Soap Company (ASC). Rowe challenges the damages calculation and rulings on the award of interest. Marietta Corporation and Nadolski cross-appeal arguing that the district court improperly granted Rowe's motion to amend his pleadings and that the court was clearly erroneous in finding that Rowe's employment contract was not part of the consideration for the sale of ASC. We AFFIRIM.

1. Background.

In March 1989, Marietta purchased Donald Rowe's 90 percent interest in ASC. Thomas Blair and John Nadolski, Marietta's principal officers at the time of the sale, were later convicted of various crimes involving fraudulent activities. Nadolski was convicted of securities fraud for falsifying, earnings and sales reports. (J.A. 197, 283.) Blair pleaded guilty to a number of crimes, including embezzlement. (J.A. 196.)

Several negotiations had occurred prior to the 1989 sale. In 1987, Marietta proposed a purchase deal that included a substantial amount of Marietta stock and an "earnout" provision. The earnout provision required that Rowe accept, as partial consideration for the sale of his business, a percentage of the profits of the merged

corporation over a period of years. The provision's structure, however, granted Rowe only a percentage of the profits above certain earnings thresholds, set higher for each succeeding year. If the merged corporation's earnings failed to meet that threshold, Rowe would receive nothing from the provision. Thus, the earnout provision entitled Rowe to the conditional right to a percentage of profits, with the risk factor that the outcome was contingent upon the merged corporation's success in the marketplace.

Rowe declined to sell in 1987 because Marietta had no real business record. Rowe lacked confidence that the risk in accepting such consideration was worthwhile. As Marietta's reports began showing increased earnings, Rowe's confidence also increased. Marietta represented increases in net sales between 1986 and 1987 of 33.37 percent and 53.5 percent between 1987 and 1988; it also represented that profitability had grown by 42.41 percent between 1986 and 1987 and 36.61 percent between 1987 and 1988. However, these representations were false. Over three years, Marietta overstated its net income by $1.7 million, or 37 percent. (J.A. 208-09.)

Despite having refused to sell on the 1987 terms, Rowe accepted very similar terms in 1989 after Marietta's profit figures added confidence that the risk was attractive. As consideration for Rowe's 90% stock of ASC, Rowe received five components:

1. $4,827,3 10 in unallocated cash;
2. $1,350,000 in cash, allocated to a non-compete agreement;
3. A 10 year, 7% per annum interest-bearing, subordinated note with a face value of $2,700,000 convertible into up to 180,000 shares of unregistered, restricted Marietta common stock at a $15.00/share conversion price on or after March 10, 1990, to which the court attributed a present value, as of March 17, 1989, of $1,884,716;
4. The right to contingent payments under the "earnout," based on one-half of all ASC's glycerine net earnings, and one-half of all soap business profits of ASC and Marietta before interests and taxes over fixed thresholds; and
5. 350,100 shares of common stock (hereinafter the "transaction shares") in Marietta, legended as unregistered and subject to preemptive rights.

Rowe brought an action for the damages suffered as a result of entering that contract. The action was heard by bench trial, with substantial pre-trial stipulations and a reliance on significant post-trial briefing. The district court found that Rowe was fraudulently induced by the Defendants, Marietta and Nadolski, to enter into the sale of ASC. (J.A. at 219-21.) It further found that this fraud constituted a violation of both federal and state law. (J.A. at 253.) The court entered judgment against the Defendants,

jointly and severally, in the amount of $395,717. (J.A. at 253.)

II. Issues.

Rowe presents three issues on appeal. The first two ask whether the district court erred in calculating damages in connection with the March 17, 1989, sale by Rowe of his 90% interest in ASC. Specifically, Rowe asks this court to determine whether the district court erred in calculating damages in connection with Rowe's losses in his transactions of Marietta stock in the open market; and whether he was entitled to an award under the earnout provision. Rowe also attacks the district court's determinations in relation to the award of interest. He asks first whether the district court erred in failing to award post-judgment interest at the New York rate; and second, whether the district court erred in failing to award compound interest (both pre- and post-judgment).

Marietta's cross appeal requires us to determine whether the trial court improperly granted Rowe's motion to amend the pleadings, and as a related issue, Marietta asks us to consider whether the evidence demonstrated that $750,000 paid under an employment contract was actually consideration for Rowe's interest in ASC.

III. Damages Issues.

A. Standard Of Review

The District Court's damage calculation should be affirmed unless it is clearly erroneous. See Fed. R. Civ. P. 52(a). See also, e.g., Smith v. Manausa, 535 F.2d 353, 354 (6th Cir. 1976) (concluding, in a securities fraud case, that "[i]n a non-jury action a trial court's determination of damages is reviewable only for abuse of discretion, subject to being set aside as a finding of fact under the 'clearly erroneous' standard"); Never v. United States, 845 F.2d 641, 644 (6th Cir. 1988). A finding made by the district court is clearly erroneous only if "the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." Anderson v. City of Bessemer City, 470 U.S. 564, 573 (1985) (quoting United States v. United States Gypsum Co., 333 U.S. 364, 395 (1948)). Thus, the District Court has broad discretion in fashioning damages for securities fraud and common-law fraud, and its determination can be reversed only upon a showing by the appellant that the Court abused that discretion. See, e.g., Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 651 F.2d 615, 620-21 (9th Cir. 1981) ("It is for the district after becoming aware of the nature of the case, to determine the appropriate measure of damages in the first instance. The court's function is to fashion the remedy best suited to the harm." (internal citations omitted)). See also Blackie v. Barrack , 524 F.2d 891, 909 (9th Cir. 1975); Arthur Young & Co. v. Reves, 937 F.2d

1310, 1336 (8th Cir. 1991), aff'd, 507 U.S. 170 (1993); Hackbart v. Holmes, 675 F.2d 1114, 1121 (10th Cir. 1982); Pelletier v. Stuart-James Co., 863 F.2d 1550, 1558 (11th Cir. 1989).

B. Analysis

1. Standard for Measuring Damages

The district court determined that the "out-of-pocket" measure of damages was the most appropriate measure of damages to use in this case. (See J.A. at 191, 232.) The district court's calculation should be affirmed.

The out-of-pocket measure is the favored method of computing damages in a securities fraud case. See, e.g., Stone v. Kirk, 8 F.3d 1079, 1092 (6th Cir. 1993) ("The correct measure of damages in cases arising under 10(b)/Rule 10b-5 is generally held to be, an 'out of pocket' measure."). It is also the preferred method of damage computation under New York law for fraud eases. See, e.g., Lama Holding Co. v. Smith Barney Inc., 668 N.E.2d 1370, 1373 (N.Y. 1996) (measure of damages for fraud is out-of-pocket).

The out-of-pocket measure of damages seeks to compensate the defrauded party for the loss caused by the fraud, calculated as of the date of the transaction. In determining out-of-pocket damages, "[t]he difference between the value of what [the defrauded investor] got and

what it was represented he would be getting is not the measure; out-of-pocket damages are limited to the excess of what he paid over the value of what he got . . . ." Stone, 8 F.3d at 1093 (quoting Levine v. Seilon, Inc., 439 F.2d 328, 334 (2d Cir. 1971)).

The District Court was therefore required to determine (i) the price Rowe paid -- the value of Rowe's 90% interest in American Soap, and (ii) the value of what Rowe received -- the combination of cash, Earnout, Note and Transaction Shares. Contrary to Rowe's argument, this calculation neither contemplates an unjust enrichment analysis nor allows the court to ignore profits Rowe received due to the fraud when determining Rowe's damages. After reviewing the records and considering the expert testimony, the district court found that Rowe's share of ASC was worth $13,654,008 on the transaction date. This calculation is not in dispute and the district court was within its authority in making such a determination. The court then considered the value of the consideration Rowe received. On the date of this transaction, the court valued the cash at $6,177,310, the Note at $1,884,716, and the earnout at $3,600,000. The court proceeded to determine that the transaction shares were worth $5.17/share at the time of the transaction for a total value of $1,809,142. Adding the figures, the court determined Rowe gave up $13,654,008 and received $13,471,168 -- a difference of $182,840. Finally, because the open market shares were inflated by the fraud on the

market, the court determined that Rowe overpaid $212,877 for the shares. Thus, the total award was $395,717.

2. Calculation of the Loss on the Transaction Shares

The district court applied the out-of-pocket standard, finding damages in the amount of $182,840. The district court found that an analysis of the transaction shares alone may have shown a $603,344 difference when determining the amount the transaction shares were inflated, after calculating the value and offsetting the gains Rowe received. But, when applying the out-of-pocket method to the entire acquisition, Rowe's total actual damages amount to only $182,840. (J.A. at 249.) This finding is not clearly erroneous and it was within the court's discretion to tailor the remedy to Rowe's actual harm. Reves, 937 F.2d at 1336; Pelletier, 863 F.2d at 1558; Hackbart, 675 F.2d at 1121; Arrington, 651 F.2d at 621; Blackie, 524 F.2d at 909.

3. Open Market Transactions

A remaining issue is whether the district court erred in calculating damages in connection with Rowe's fraudulently induced losses in his transactions of Marietta stock in the open market. The district court correctly determined that only the losses attributable to the fraud could be recouped and that any losses from unrelated market risks are not recoverable. The loss must be proximately caused by the fraud under both the requirements of 10b-5, see, e.g., Ballan v. Upjohn, 159 F.R.D. 473, 483 (W.D.

Mich. 1994) and In re Mut. Sav. Bank Sec. Litig., 166 F.R.D. 3 77, 3 83 n. 10 (E.D. Mich. 1996), and the requirements of a New York common law fraud claim. See, e.g., Northwestern Nat'l Ins. Co. V. Alberts, 769 F.Supp. 498, 505 (S.D.N.Y. 1991); Banque Franco-Hellinique v. Christophides, 106 F.3d 22, 27 (2d Cir. 1997).

After finding that a substantial part of the decline in the value of the open market shares was attributable to causes other than the fraudulent financial statements, the district court proceeded to determine the amount the shares were inflated by the fraud and how much of the inflation had been removed from the shares when Rowe sold them. The court awarded Rowe the difference, $212,877. The method selected, the out-of-pocket calculation, was appropriate, the findings of fact were not clearly erroneous, and the damages award was not an abuse of discretion.

4. Earnout

Marietta claims that Rowe waived any claim under the Earnout. Marietta claims that Rowe told the District Court several times that he was not seeking damages under

the Earnout[1] and that the district court relied on these representations.[2]

Yet Rowe contends that these statements only related to pursuit of a fraud-in-the-execution claim and that he was not abandoning his fraud-in-the-inducement claim - i.e. that he would never have agreed to accept the Earnout as a consideration or at least would be unwilling to accept such high thresholds had he known Marietta's potential for reaching those thresholds was fraudulently represented.

---

[1] "And I will tell Your Honor that we are not seeking damages under the BIT." (J.A. at 461 (opening statement of Rowe's counsel)); "[W]e will not try to prove that we were damaged by the BIT at this trial." (Donald Rowe, J.A. at 557); "[W]e have announced to the Court in my opening statement that we are not seeking damages for the BIT." (J.A. at 487 (Rowe's counsel)).

[2] See J.A. at 489 (Court: "I believe this Earnout is out of the case."); J.A. at 492-93 (Court refers to Rowe's counsel's "statement at the outset [ ] -- that you have -- that you are not pressing the EBIT claims."); J.A. at 191, 226 n.39 ("At trial, Rowe announced that he was not pursuing recovery based on any part of the total earnout package. See, e. g., Oscanyan v. Arms Co., 103 U.S. 261 (1880); Ferguson v. Neighborhood Hous. Servs. 780 F.2d 549, 550-551 (6th Cir. 1986); Curb v. MCA Records, Inc., 898 F. Supp. 586, 591 (M.D. Tenn. 1995) ("The Sixth Circuit has determined that oral representations by counsel in the course of litigation constitute binding judicial admissions") (citing Berlin v. Celotex Corp., 912 F.2d 465, 1990 WL 125360 (6th Cir. 1990) (unpublished opinion)).

Rowe claims that the fraud in the inducement makes the Earnout Clause void.

Because Rowe continued to make this claim in post-trial briefing (see J.A. at 441-42), and attempted to make the argument at trial (J.A. at 550-55), it is at least questionable as to whether he waived this claim. We will assume first that Rowe may appeal this issue. Because even when giving Rowe the benefit of this assumption the district court's ruling is affirmed, we need not decide the preceeding issue of waiver.

Rowe's principal criticism of the district court's analysis is that the court valued the earnout at $3.6 million, the figure that Rowe valued it at on the date of the transaction rather than at $69,876, the value that Rowe actually received pursuant to the earnout provision of the purchase agreement. (See Rowe Br. at 24-25.) Rowe contends that he is entitled to the difference, i.e., to the earnout shortfall.

Instead of bargaining for a sum certain, Rowe accepted a risk that the merged corporation would meet the earnout thresholds. He must accept the value of the right to the earnout at the time of the transaction. Thus, in calculating out-of-pocket damages, $3.6 million was considered part of the "value of what he got." There is no evidence that the fraud affected the merged corporation's

ability to produce and profit. Market forces, not fraud, prevented Marietta from reaching the profit thresholds set in the earnout clause.

Consequently, Rowe's attempt to collect the earnout shortfall fails because the out-of-pocket measurement allows a plaintiff to recover only such losses as are proximately caused by the fraud. See Fryling v. Merrill Lynch, Pierce, Fenner & Smith, 593 F.2d 736, 743-44 (6th Cir. 1979) (recognizing loss causation as a separate element of section 10(b)/Rule 10b-5 claims, and that plaintiff cannot recover damages caused by market decline). Rowe's attempt to distinguish between fraud in the inducement and fraud in the execution is irrelevant. Under Rule 10(b)5 and analogous New York common law fraud claims, the investor must both rely on the misstatement in deciding to invest and the misstatement must be the proximate cause of his loss - i.e., he must prove loss causation. Campbell v. Shearson/American Express Inc., 829 F.2d 38, 1987 WL 44742, *2 (6th Cir. 1987)(citing Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 198 1), aff'd in part, rev'd in part on other grounds, 459 U.S. 375 (1983)). Huddleston explains:

> The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss. The causation

> requirement is satisfied in a Rule 10(b)-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value. If the investment decision is induced by misstatements or omissions that are material and that were relied upon by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule is not permitted. Absent the requirement of causation, Rule 10(b)-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission.

Huddleston, 640 F.2d at 549 (footnotes and citations omitted). Rowe's loss resulted from the failure of Marietta to earn beyond the thresholds established under the earnout clause. He accepted that risk and the district court's valuation of the earnout in light of the risk was not erroneous. Because there is no evidence that the fraud was the proximate cause of Marietta's inability to earn beyond the thresholds, the district court's findings will not be disturbed.

IV. Interest.

The District Court awarded Rowe pre-judgment interest at 9% per annum. (J.A. at 191, 252). Federal law controls the questions of whether and how much pre-

judgment interest to award on Rowe's federal securities claim, and New York law governs the questions on Rowe's New York fraud claim. See Blau v. Lehman, 368 U.S. 403, 414 (1962); Mallis v. Bankers Trust Co., 717 F.2d 683, 692, n. 13 (2d Cir. 1983); see also Bailey v. Chattem, Inc., 838 F.2d 149, 152 (6th Cir. 1988) (whether to award prejudgment interest is a substantive issue governed by Klaxon v. Stentor Elec. Mfg., 313 U.S. 487 (1941)). (J.A. at 191, 251.) Because the district court found that Rowe prevailed on both his federal and state law claims, and awarded identical damages on both sets of claims, the question of pre-judgment interest must be analyzed under both New York and federal law.

The prejudgment interest on Rowe's New York fraud claim is established by statute at 9% per annum. See N.Y.C.P.L.R. §§5001, 5004. Under federal law, the award of prejudgment interest on an award pursuant to §10(b) is within the trial court's discretion. By choosing the New York rate of 9% per annum interest, the district court did not abuse its discretion. See Commercial Union Assurance Co. v. Milken, 17 F.3d 608, 614 (2d Cir. 1994)(the trial court's award of prejudgment interest should not be reversed except for an abuse of discretion); Knapp v. Ernst & Whinney, 90 F.3d 1431, 1441(9th Cir. 1996)(same). See also Grogan, 806 F.2d at 839 (law of higher award appropriately applied). Furthermore, Rowe's plea for compound instead of simple interest is equally without

merit. Section 5004 prescribes a simple rate of interest. See N.Y.C.P.L.R. §§5001, 5004; Kaufman v. LeCurt Constr. Corp. 196 A.D.2d 577, 601 N.Y.S.2d 186 (2d Dep't 1993); Long Playing Sessions, Inc. v. Deluxe Laboratories, Inc., 514 N.Y.S.2d 737 (N.Y. 1st Dept. 1987); SEC v. Musella, 748 F. Supp. 1028 (S.D.N.Y. 1989). See also Cherokee Nation v. United States, 270 U.S. 476, 490 (1926)(simple interest is preferred over compound in the award of pre-judgment interest); Quesinberry v. Life Ins. Co., 987 F.2d 10 17 (4th Cir. 1993)(same).

The district court has not yet been required to rule on the issue of compound interest. Rowe contends that the district court should apply the New York rate for post-judgment interest and that it should be compounded. Because the district court has not yet ruled, there is nothing to review. Nevertheless, we note that post-judgment interest on a federal civil judgment is governed by federal statute, regardless whether the underlying claim arises under federal or state law. See 28 U.S.C. §1961 (providing that post-judgment interest on all federal civil judgments "shall be calculated from the date of the entry of the judgment, at a rate equal to the coupon issue yield equivalent (as determined by the Secretary of the Treasury) of the average accepted auction price for the last auction of fifty-two week United States Treasury bills settled immediately prior to the date of judgment."); Carte Blanche (Singapore) Pte., Ltd. v. Carte Blanche Int'l, 888 F.2d 260, 268-69 (2d Cir. 1989).

Furthermore, section 1961(b) specifically states that such interest "shall be compounded annually." 28 U.S.C. §1961(b).

V. Amended Pleadings.

At the commencement of trial, Rowe amended his pleadings, contending that the $750,000 that he received from Marietta during the period 1987 through 1992 was for employment and not payment in consideration for his interest in ASC. Rule 15(a) of the Federal Rules of Civil Procedure requires that leave to amend "shall be freely given when justice so requires." FRCP 15(a). A district court's decision whether to grant a motion to amend is reviewed for abuse of discretion. See Robinson v. Michigan Consol. Gas Co., 918 F.2d 579, 591 (6th Cir. 1990).

Marietta and Nadolski claim that, because the amendment came so late in litigation preparation and because Rowe had made representations prior to the amendment that the contract was consideration, defendants were prejudiced by being unable to establish an appropriate response strategy to Rowe's claim. As such, they argue that the district court's decision to allow amendment was an abuse of discretion. Although a court may deny leave to amend where there is undue delay, bad faith or dilatory motives by the movant, undue prejudice to the opposing party, or futility of the amendment, Foman v. Davis, 371

U.S. 178, 182 (1962), it must grant leave unless one of these factors is present. Id.

We agree with the district court in finding that, "[n]either Marietta nor Nadolski is unduly prejudiced by allowing the amendment." (J.A. at 205.) Marietta did not establish a sound contention of prejudice, nor did it prove bad faith. It named no witnesses it could have called had it known earlier of the amendment and described no documentary evidence it wished to obtain as a result of the amendment. While the amendment certainly required that Marietta and Nadolski make additional arguments to defeat the claim, that alone is not prejudicial. Thus, the decision to grant the motion to amend was not an abuse of discretion.

VI. The Employment Contract.

Pursuant to Fed. R. Civ. P. 52(a), findings of fact by a district judge should not be reversed unless "clearly erroneous." Marietta argues that the $750,000 paid to Rowe pursuant to an employment contract was actually part consideration for the sale of ASC. Here, the $750,000 was executed in a separate employment agreement. Sufficient evidence was available to support the district court's finding that the $750,000 was for employment and we are not left with a definite and firm conviction that the district court has made a mistake. See Anderson V. City of Bessemer City, 470 U.S. 564, 573 (1985); accord Bartling v. Fruehauf Corp, 29 F.3d 1062, 1067 (6th Cir. 1994); Owens-Illinois,

Inc. v. Aetna Cas. & Sur. Co., 990 F.2d 865, 870 (6th Cir. 1993). Thus, the finding that the sum was separate from consideration for the sale of ASC is not clearly erroneous.

VI. Conclusion

For the forgoing reasons, we AFFIRM.

97-5789/5791/5892

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

FILED
FEB. 09 1999

DONALD M. ROWE **LEONARD GREEN**
Clerk

Plaintiff - Appellant/Cross-Appellee,

v.

MARIETTA CORPORATION; JOHN S. NADOLSKI,
Defendants-Appellees/Cross-Appellants.

BEFORE: BOGGS, SUHRHEINRICH and SILER, Circuit Judges.

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and no judge of this court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

/s/ Leonard Green

Leonard Green, Clerk

APPENDIX B

Opinion of the District Court for The Western District of Tennessee

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IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TENNESSEE
WESTERN DIVISION

DONALD M. ROWE, J. DONALD ROWE, MASELLA B. ROWE, and CALIFORNIA SOAP CO., INC.,

Plaintiffs,

vs. No. 92-2963-D

MARIETTA CORPORATION and JOHN NADOLSKI,

Defendants.

FINDINGS OF FACT AND CONCLUSIONS OF LAW FOLLOWING NON-JURY TRIAL

INTRODUCTION

On March 17, 1989, Marietta Corporation (Marietta), a New York corporation headquartered in Cortland, New York, acquired American Soap Company (ASQ, formerly a Mississippi corporation headquartered in Olive Branch, Mississippi, in a complex stock and asset purchase agreement. Plaintiff Donald M. Rowe (Rowe) owned 90% of ASC prior to the acquisition.

In bringing suit against Marietta, Rowe alleged violations of statutory federal and state securities laws, state consumer protection laws, and RICO,[1] as well as claims of common law fraudulent inducement, negligent misrepresentation, and breach of contract. J. Donald Rowe, Masella B. Rowe and California Soap Company, Inc. (CSC), asserted violations of RICO, as well as claims for state law fraud, negligent misrepresentation, and breach of contract.[2]

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[1]Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968, Title IX of the Organized Crime Control Act of 1970, Pub. L. 91-452, 84 Stat. 92-1 (1970).

[2]As the case labored through the dispositive pre-trial proceedings, many of the plaintiffs' claims were either withdrawn or dismissed. Finally, in the joint pre-trial order, the Court allowed all plaintiffs other than Donald M. Rowe to withdraw their claims without prejudice.

At this non-jury trial, Rowe alleged that Marietta and co-defendant John Nadolski:

1) Violated 15 U.S.C. §§ 78j(b) and 78t(a) and 17 C.F.R. § 240.10b-5, by making untrue statements or omissions of material fact to Rowe, or by practicing fraud or deceit upon Rowe, in connection with the purchase or sale of securities.

2) Practiced common law fraud to induce Rowe to sell to Marietta his interest in ASC and to purchase shares of Marietta common stock on the open market.

Rowe pleaded two distinct areas of damage in his complaint, to-wit:

1) that, in signing the closing documents on March 17, 1989, Rowe was proximately damaged by his reliance on the defendants' fraudulent misrepresentations; and,

2) that, in subsequent transactions of Marietta stock, Rowe was proximately damaged by his reliance on the defendants' fraudulent misrepresentations.

The contested issues of fact before the trial court were:

1) Whether John Nadolski told Rowe at a December 1988 meeting that Marietta was "on target" to meet its sales projections of $6,500,000 for the first quarter of Marietta's fiscal year 1989.

2) Whether Rowe relied on the financial misrepresentations of Marietta and Nadolski.

3) Whether Rowe suffered damages as the result of the sale of ASC to Marietta, and, if so, the amount thereof.

4) Whether Marietta and Nadolski benefited as the result of fraud practiced upon Rowe in the acquisition of ASC or the inflation of Marietta stock prices between 1989 and 1991, and, if so, the amount thereof.

5) When Rowe knew or should have known whether he had been defrauded in the acquisition of ASC or the inflation of Marietta stock between 1989 and 1991.

6) Whether the alleged misstatements by Marietta and Nadolski were the proximate cause of any loss suffered by Rowe.

7) What the value of Rowe's share of ASC was on March 17, 1989.

8) What the value was of the consideration received by Rowe on March 17, 1989, for his 90% share of ASC.

This Court has jurisdiction pursuant to 15 U.S.C. § 78aa, 28 U.S.C. § 1331, and principles of supplemental and ancillary jurisdiction. This memorandum opinion constitutes the Court's findings of fact and conclusions of law, in

accordance with Rule 52 of the Federal Rules of Civil Procedure.

BACKGROUND

Rowe founded ASC in July 1976, in Olive Branch, Mississippi, with a $50,000 capital investment and 12-15 employees. From ASC's inception until immediately prior to its acquisition by Marietta, Rowe was the beneficial owner of all outstanding ASC capital stock, as well as being ASC's Chairman and President.[3] Huey L. Holden began working at ASC in 1976. Holden quickly advanced to become ASC's Senior Vice President and later its Chief Operating Officer, running ASC's daily operations and reporting only to Rowe. After several years of working for ASC with no vested interest, Holden acquired options to purchase up to 20% of the capital stock of ASC. Immediately prior to the March 17, 1989 closing, Holden exercised an option to acquire 10% of the ASC capital stock. As consideration for the exercise of this option, and in lieu

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[3]At all times material to this case, Rowe held, in addition to ASC, interests in several other business ventures. Along with his parents, Rowe was a beneficial owner of J.D. Rowe & Company, J.D. Rowe, Inc., and California Soap Company (CSC). CSC owned real property and assets located in Olive Branch, Mississippi which were integral to the ASC operation. CSC also functioned as a distributor and warehouser of ASC products in California.

of any cash consideration, Holden waived his option to acquire another 10% of the ASC capital stock.

ASC began its operations as a soap finisher[4] in 1976. At its inception, ASC's only client was the Holiday Corporation, the parent company of Holiday Inns. Between 1976 and 1989, ASC expanded from a 10,000 square foot facility to a 140,000 square foot facility, and the number of employees grew from 12-15 to approximately 220. In 1989, ASC expanded from operating one soap finishing line to eight finishing lines, while expanding services. Selling its products through distributors, ASC's clientele grew.[5] In 1987, ASC had annual sales of over $17,000,000, and was a vertically integrated operation, manufacturing and packaging the soap itself.[6]

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[4]ASC purchased soap chips from soap manufacturers, and then blending the soap with perfumes and dyes. Then it refined, extruded, cut, pressed, and wrapped the soap, creating a finished product for sale to the lodging and travel industries.

[5]To include, *inter alia,* Marriott Hotels, La Quinta Inns, Red Roof Inns, Knights Inns, Best Western Inns, Sheraton Hotels, Hilton Hotels, Delta Airlines, Trans World Airlines, American Airlines, and Northwest Airlines.

[6]Basically, there are two types of bar soap product for sale to the travel and lodging industries -- "branded" soap and "non-branded" soap. Examples of branded soap are "Dial" and "Palmolive", while the non-branded variety might be generic or might carry the name or corporate logo of the hotel or carrier in the place of a brand. ASC manufactured non-branded soap. There are pluses and minuses to each variety. Carrying a familiar national name, branded soap is preferred by most of the end users

Beginning in 1986, ASC extracted crude glycerine, a world commodity, as a by-product of the saponification process and attempted to refine the glycerine for sale. Holden testified that ASC never perfected the glycerine refinement process, and, as a result, failed in its attempts to refine the glycerine to marketable qualities and achieve profitability. Furthermore, according to Holden, ASC's supply of glycerine "was just a blip in the market." The glycerine market suffered a steady decline in price during the time relevant to this case.

ASC regularly loaned money to other businesses controlled by Rowe or his family, at times approximating 25% of ASC's net worth. The practice of borrowing operating capital from ASC for infusion into companies in which Holden had no proprietary interest, potential or otherwise, caused understandable friction between Rowe and

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-- the hotel guests, airline passengers, etc. However, nonbranded soap has its own advantages. Some larger units of the lodging and travel industries prefer to provide their patrons with non-branded soap and amenities bearing the hotel's or the airline's name or corporate logo. With branded soap, this practice can confuse the guest or passenger. Non-branded soap, like a blank tablet, does not cause the same problem. Also, importantly, non-branded soap is typically less expensive to the providing entity. The evidence leads the Court to conclude that in recessionary times, manufacturers of non-branded soap suffer fewer demand decreases than do manufacturers of non-branded soap, and, accordingly, the industry as a whole.

Holden. Eventually, Rowe consented to abide by certain procedural measures with respect to his borrowing practices. These bureaucratic safeguards were put in place to protect ASC from capital depletion and to strengthen the company's management procedures, in hopes of someday taking ASC public.

Marietta[7] was incorporated in 1976 in Cortland, New York, by John Nadolski. Primarily, Marietta was a packager of guest amenity items, i.e., shampoo, lotion and cosmetics, for the lodging industry. Most Marietta products were unbranded; however, Marietta did include some brand name products in its packages and succeeded in establishing well known product lines of its own invention. Until its acquisition of ASC, Marietta did not regularly market soap in its amenities packages. Marietta also packaged amenities for sample and unit-of-use marketing.

Marietta went public with the filing of a Form S-1 with the Securities and Exchange Commission (SEC), on June 11, 1986, precedent to its initial public offering. Its shares were traded on the over-the-counter market of the NASDAQ[8] National Market System (NASDAQ), a national exchange regulated by the SEC. As a public company,

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[7]On March 31, 1986, Marietta changed its name from Marietta Packaging Company, Inc., to Marietta Corporation.

[8]National Association of Securities Dealers Exchange.

Marietta was registered with the SEC and required by law to file quarterly (10-Q) and annual (10-K) reports. For accounting and reporting purposes, Marietta's fiscal year began on October 1 and ended on September 30.

At all times relevant to this case, Nadolski was the President, Chief Executive Officer, and a director of Marietta. As of February 9, 1989, Nadolski was the beneficial owner 424,000 shares of Marietta common stock. Thomas Blair was the Secretary-Treasurer, Chief Financial Officer, and a director of Marietta from 1987 until 1991, when his employment was terminated. Victor Siegle was Marietta's Executive Vice President and a director, until his departure from Marietta in 1988.

Blair admitted to embezzling more than $400,000 from Marietta and pleaded guilty in the Northern District of New York (Case No. 92-CR-246) to illegally moving more that $5,000 in interstate commerce, in violation of 18 U.S.C. §2314, and to conspiring to commit perjury, in violation of 18 U.S.C. § 371.[9]

Blair is a felon convicted of a crime of dishonesty, to-wit, perjury. The Court notes that in his videotaped deposition, Blair admitted that he often tied to protect his

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[9]Rowe introduced Blair's videotaped deposition testimony at trial.

interests. Based on the testimony of the witness, including his demeanor and his lack of candor in his daily affairs, the Court finds Blair's credibility as a witness generally suspect. Thus, the Court, after hearing Blair's testimony in full, accorded it little weight.

Nadolski was tried and convicted in the United States District Court for the Northern District of New York of four violations of federal securities laws, to-wit:

1. unlawfully, knowingly and wilfully making and causing to be made false and misleading statements as to material facts in the quarterly report on Form 10Q for Marietta, for the first quarter of the fiscal year ended September 30, 1989, said quarter covering the months of October, November and December, 1988, which was filed with the SEC on or about February 14, 1989, in violation of 15 U.S.C. §§ 78m(a) and 78ff, 18 U.S.C. § 2, and 17 C.F.R. § 240.13a-13;

2. unlawfully, knowingly and wilfully making and causing to be made false and misleading statements as to material facts in the annual report on Form 10-K for Marietta, for the fiscal year ended September 30, 1989, which was filed with the SEC on or about December 28, 1989, in violation of 15 U.S.C. §§ 78m(a) and 78ff, 18 U.S.C. § 2, and 17 C.F.R. § 240.13a-1;

3. unlawfully, knowingly and wilfully, by use of means and instrumentalities of interstate commerce and the mails, directly and indirectly, on or about and between February 14, 1989 and November 6, 1989, using and employing manipulative and deceptive devices and contrivances in connection with the purchase and sale of securities, that is, the stock of Marietta, and (a) employing a device, scheme and artifice to defraud, and (b) making untrue statements of material facts and omitting to state material facts in order to make the statements made, in light of the circumstances under which they were made, not misleading, and (c) engaging in acts, practices and a course of business which would and did operate as a fraud and deceit upon Tucker Anthony Corporation and the public, in connection with the purchase and sale of Marietta stock, in violation of 15 U.S.C. §§ 78j(b) and 78ff, 18 U.S.C. § 2, and 17 C.F.R. § 240.10b-5; and,

4. unlawfully, knowingly and wilfully falsifying, concealing and covering up by trick, scheme and device a material fact, and making false, fictitious and fraudulent statements and representations, and making use of a false writing and document to contain a false, fictitious and fraudulent statement and entry, to-wit: the overstatement as to sales reported in the quarterly report on Form 10-Q for Marietta, for the first quarter of the fiscal year ended September 30, 1989, said quarter covering the months of October, November and December, 1988, and said report

filed with the SEC on or about February 14, 1989, in violation of 18 U.S.C. §§ 2 and 1001.

In the same proceeding, Nadolski was tried and acquitted of one count of conspiracy to commit securities fraud in violation of 18 U.S.C. §§ 371 and 1001, and of one count of securities fraud in violation of 18 U.S.C. §§ 2 and 1001. Nadolski did not testify at trial.

Marietta was characterized as a "growth company" among investment analysts, meaning that the analysts expected continued growth of Marietta's earnings per share of 20-25% annually. Maria de Lucia, a senior equity analyst for the investment consulting concern Tucker Anthony, researched and authored all Tucker Anthony investment reports on Marietta during the relevant time period. In arriving at a "Buy", "Sell", or "Hold" recommendation to be distributed to potential and actual investors in Marietta, de Lucia analyzed the company's historic income statements and income projection models, investigated trends affecting sales, costs, etc., and conversed with company management. She received her information on Marietta's financial health and market position primarily from Nadolski and Blair.

Between 1984 and 1989, Rowe considered various ways of raising capital for ASC. At trial, Rowe and Holden both testified that raising capital for ASC was a major consideration during the relevant time period, given the

capital-intensive nature of the soap-making business. After engaging the investment banking firm Morgan Keegan for consultation, Rowe decided against an initial public offering.

ASC held discussions with Great Lakes Pen and Pencil Company, a Canadian amenities company, for the acquisition of Great Lakes by ASC, but the talks were unfruitful. Additionally, the Dial Corporation briefly considered ASC as a potential target of acquisition, but that deal never materialized. Finally, during this time frame, ASC learned that it had not won a contract to be a supplier for Guest Supply, Inc. -- a contract which would have generated an additional $6,000,000 in gross annual sales for ASC.

NEGOTIATIONS FOR THE ACQUISITION OF ASC

In late 1986, Nadolski contacted Rowe to discuss the possible merger of ASC and Marietta. Between 1986 and 1987, Nadolski, Blair, and Siegle entered into formal negotiations with Rowe and Holden which led to an offer by Marietta for 100% of ASC's capital stock. The main components of this first bid were 1) Marietta stock, valued at the time at $12.75/share, and 2) a complex earnout agreement developed by Siegle, contingent upon ASC's future performance, in exchange for all outstanding ASC capital stock.

The first round of merger negotiations failed primarily because Rowe was reluctant to accept consideration mostly in the form of Marietta stock and the Siegle eamout package. Rowe testified that he would have received as little as $2,000,000 in cash consideration on the front end of this first purchase offer. Marietta's short track record as a public company, coupled with the fact that the bulk of the consideration for Rowe's interest in ASC would be both future and contingent, made the merger unacceptable to Rowe in 1987.

However, talks involving some type of joint venture or mutual distributor- or agent relationship between ASC and Marietta continued, primarily between Nadolski and Holden. In these discussions, Nadolski and Holden explored ways to optimize, in a non-merger setting, the perceived synergy in the companies' complementary product lines, client bases, and geographical locations. Because ASC and Marietta produced different amenities for the lodging industry, because their customer bases were different, and because their operations were situated in distant geographical market areas, it appeared that cooperation between the two companies and the combination of the companies' product lines would make the joint venture a "one stop shop" for distributors and direct-sale clients. As a practical matter, no substantial business between ASC and Marietta developed from these talks.

During the first half of 1988, Rowe and Nadolski resumed negotiations for the acquisition of ASC by Marietta. Rowe was placed on Marietta's mailing list -- to receive press releases, corporate filings, and other materials. According to the testimony of both Rowe and Holden, one of the main reasons that Marietta and ASC were able to resume talks concerning the possible merger or acquisition was that Siegle had resigned from Marietta during the interim. By October 1988, the parties reached an agreement in principle on the basic components of the acquisition, i.e., the structure of the deal if not the actual values, contingent upon certain subsequent conditions, including ASC's success in meeting its 1988 projections and Marietta's performance in the first quarter of fiscal 1989. Nadolski and Rowe met at Marietta's corporate headquarters in Cortland, New York, on December 14, 1988, at-which time Nadolski assured Rowe that Marietta was "on target" to reach its sales projection of $6,500,000 for the first quarter of fiscal 1989.

In order to meet the $6,500,000 sales projection, Nadolski and Blair caused the creation of $1,000,000 in fraudulent sales for the quarter. In the 10-Q for the first quarter of fiscal 1989, filed February 15, 1989, Marietta reported net sales of $6,487,000 and net income of $489,000. Had Marietta not overstated sales by $1,000,000, the company would have posted a $297,000 net loss for the quarter. Additionally, based on the $1,000,000 fraudulent inflation of its sales for the first quarter of fiscal 1989,

Marietta posted earnings per share for that quarter of $0.23. Marietta's real sales for the first quarter of fiscal 1989 would have generated an actual loss of $0.14 per share.

For the fiscal years 1987, 1988, and 1989, Marietta filed 10-K's with the SEC, overstating gross profits, net income, and earnings per share. These false statements (rounded) and the corresponding true results (rounded) are encapsulated in the charts below:

Fiscal 1987	False Statements in 10-K	True Results in 3/18/92 Form 8 (1987)
Gross Profits:	$5,555,000	$5,434,000
Net Income:	$1,403,000	$1,169,000
Earnings Per Share:	$0.59	$0.49

Fiscal 1988	False Statements in 10-K	True Results in 3/18/92 Form 8 (1988)
Gross Profits:	$8,132,000	$7,797,000
Net Income:	$1,917,000	$1,665,000
Earnings Per Share:	$0.80	$0.70

Fiscal 1989	False Statements in 10-K	True Results in 12/22/92 Form 8 (1989)
Gross Profits:	$15,240,000	$14,516,000
Net Income:	$2,946,000	$1,730,000
Earnings Per Share:	$1.29	$0.79

The evidence shows that Nadolski, acting in his capacity as Marietta's CEO, director, shareholder and agent, caused the first-quarter 1989 10-Q, as well as the 1987-89 10-K's, and, additionally, corresponding annual reports, press releases, and recommendations and reports by investment bankers, to be made available to Rowe in 1988 and early 1989. The evidence further demonstrates that Rowe reviewed these statements[10] prior to entering into a binding contract to sell his interest in ASC to Marietta.

ACQUISITION OF ASC BY MARIETTA

On March 17, 1989, Marietta acquired ASC in a stock and asset purchase transaction consummated in the State of New York. When Rowe sold his 90% stake in ASC to Marietta, Holden simultaneously sold his 10% interest. As consideration for his stock in ASC, Rowe received:

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[10]Not including the statements filed or made after March 17, 1989 (e.g., the 1989 10-K).

1) $4,827,310 in unallocated cash;

2) $1,350,000 in cash, allocated to a non-compete agreement;

3) a 10-year, 7% per annum interest-bearing, subordinated note with a face value of $2,700,000 convertible into up to 180,000 shares of unregistered, restricted Marietta common stock at a $15.00/share conversion price on or after March 10, 1990, to which the Court attributes a present value, as of March 17, 1989, of $1,884,716;

4) the right to contingent payments under the total earnout package,[11] valued by Rowe on 3/17/89 at $3,600,000; and,

5) 350,100 shares[12] of common stock in Marietta, legended as unregistered and subject to preemptive rights, valued by Rowe on 3/17/89, for tax purposes, at $3,014,361, or $8.61/share.

Combination of all of the above components of the purchase price demonstrates that, on the acquisition date, Rowe believed that he was receiving consideration in the present value amount of $14,676,387, on March 17, 1989, in exchange for the transfer of his 90% interest in ASC to

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[11]The total eamout package" includes 1) the Contingent Glycerine Earnout and 2) the Contingent EBIT Earnout.

[12]Hereinafter, the "transaction shares".

Marietta. In the same transaction, and for his 10% of all outstanding ASC capital stock, Holden received:

1) $536,368 in unallocated cash;
2) $150,000 in cash, allocated to a non-compete agreement;
3) a 10-year, 7% per annum interest-bearing, subordinated note with a face value of $300,000 convertible into up to 180,000 shares of unregistered, restricted Marietta common stock at a $15.00/share conversion price on or after March 10, 1990, to which the Court attributes a present value, as of March 17, 1989, of $209,413;
4) the right to contingent payments under the total earnout package,[13] valued by Holden on 3/17/89 at $400,000; and,
5) 38,900 shares of common stock in Marietta, legended as unregistered and subject to preemptive rights, valued by Holden on 3/17/89, for tax purposes, at $515,425, or $13.25/share.

Calculation of these figures indicates that Holden was willing to accept consideration in the present value amount of $1,811,206, for the sale to Marietta of his 10% share in ASC, on March 17, 1989. The Court notes that, in

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[13]Supra note 11.

aggregating the perceived -- or front end -- consideration (i.e., in the absence of the revelation of any fraud which would diminish the value of Marietta stock on the NASDAQ), Rowe and Holden believed themselves to be receiving consideration worth $16,487,593[14] on March 17, 1989, for 100% of ASC's capital stock.[15]

EMPLOYMENT/CONSULTING AGREEMENT

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[14]In calculating the value of ASC on the date of the transaction, the Court relied in part on one of Dr. Douglas Southard (Southard)'s six weighted methods, called the market transaction approach, infra at p. ***, in which Southard summed the expected consideration received by Rowe and Holden in order to arrive at the value of ASC on March 17, 1989. Southard's estimate of the value of the Marietta common stock component for purposes of the market transaction approach was $3,349,290. Southard arrived at this figure, in lieu of the $3,529,786 sum of 350, 100 shares valued at $8.61 /share ($3,014,361) and Holden's 38,900 shares valued at $13.25/share ($515,425), by applying a 35% discount to Holden's shares to accommodate illiquidity arising from the legended restrictions, and adding the product -- $334,929 -- to Rowe's $3,014,361, for a sum total of $3,349,290.

[15]The record also reflects that CSC owned real property and equipment which it leased to ASC. At closing, Marietta allocated $1,200,000 in cash to purchase the CSC assets integral to the ASC operation. For the purposes of this opinion, the Court finds that the $1,200,000 CSC payment is not part of the consideration Marietta paid for Rowe's 90% share of ASC, nor does the amount factor into to the Court's valuation of ASC at the time of closing.

Also at issue in the trial was whether Rowe's five-year employment contract with Marietta (converted into a consulting agreement on March 17, 1990) was in part consideration for the sale of ASC. The employment agreement provided that Rowe would receive $150,000/year for five years, in return for services rendered. The superseding consulting agreement continued the $150,000/year payment to Rowe for the remainder of the five-year term.

In the original complaint, and in all subsequent amended complaints, Rowe averred that the employment/consulting agreement was in part consideration for the sale of Rowe's ASC stock. In his pre-trial memorandum, Rowe asserted the employment/consulting agreement was not in part consideration for the sale of ASC. At trial, Rowe moved pursuant to Rule 15(b) of the Federal Rules of Civil Procedure to conform the pleadings in accordance with the proof. Marietta and Nadolski opposed the Rule 15(b) motion on grounds:

1) that the evidence adduced at trial showed that Rowe performed substantially no services for Marietta after

the transaction, but received payment in full[16] under the employment/consulting agreement; and,

2) that Rowe should be estopped from denying that the employment/consulting agreement was in part consideration for the sale of ASC, because Rowe expressly stated in three submissions to the Court (Complaint, First Amended Complaint, and Second Amended Complaint) that "[a]s further consideration for the sale of all [ASC] assets and shares of common stock, Marietta granted to D. Rowe an Employment Agreement . . ." and Rowe has not formally amended or withdrawn the admissions.

Rowe admitted that he performed substantially no work for Marietta under the employment/consulting agreement but asserted, as the reason therefor, that Nadolski deliberately excluded him from participating in Marietta's management.

At trial, the Court reserved ruling on Rowe's ore tenus motion. It is undisputed that Rowe received $750,000, between March 17, 1989 and March 17, 1994, under the

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[16]$750,000 over five years payable in five equal installments of $150,000, plus automobile and medical allowances and annual cost-of-living adjustments.

terms of the employment/consulting agreement.[17] The Court finds that the proof does in fact show that the employment/consulting agreement was not made in consideration for the sale of ASC, and that amendment of the pleadings to conform with the proof is appropriate. Such amendment should be allowed where the amendment would not cause the adverse parties undue prejudice. Fed. R. Civ. P. 15(b). The Court finds that neither Marietta not Nadolski is unduly prejudiced by allowing the amendment and concludes that, although Rowe's pleadings do constitute competent evidence, see Williams v. Union Carbide Corp., 790 F.2d 552 (6th Cir.), cert. denied 479 U.S. 992 (1986); United States v. McKeon, 738 F.2d 26 (2nd Cir. 1984); Contractor Utility Sales v. Certain-Teed Prods., 638 F.2d 1061 (7th Cir. 1981), judicial estoppel is not appropriate under the particular facts and circumstances. Cf. Teledyne Indus., Inc. v. NLRB, 911 F.2d 1214 (6th Cir. 1990); FDIC v. Butcher, 660 F. Supp. 1274 (E.D. Tenn. 1987); FDIC v. Berry, 659 F. Supp. 1475 (E.P. Tenn. 1987).

Accordingly, the Court hereby **GRANTS** Rowe's ore tenus motion pursuant to Rule 15(b) of the Federal Rules of Civil Procedure, and allows amendment to the Second Amended Complaint to reflect that Rowe's employment/consulting agreement was not in part

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[17] *Supra* note 16.

consideration for the sale of ASC to Marietta. Further, the Court finds that the monies paid to Rowe under the employment/consulting agreement do not constitute consideration for Rowe's 90% interest in ASC.

POST ACQUISITION EVENTS AND ROWE'S PURCHASE OF THE OPEN MARKET SHARES

Following the acquisition of ASC, the price of Marietta stock rose sharply. Less than one month after the closing,[18] Marietta was trading for $15.00/share on the NASDAQ -- the strike price for Rowe's conversion rights pursuant to the note[19] - and did not dip below the strike price again until August 23, 1990. On May 11, 1989, Marietta broke the $20.00/share mark and hovered around $22.00/share for the next five months.[20] Finally, Marietta climbed again over the $20.00/share mark on October 30, 1989, to remain above that watershed mark until August 13, 1990. In sum, during the 24 months following Marietta's

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[18]April 7, 1989. *See* Appendix A to Findings of Fact and Conclusions of Law Following Non-Jury Trial (Appendix A), line 7.

[19]However, under the terms of the note, Rowe's right to convert the note into Marietta stock did not vest until March 10, 1990.

[20]During this time period, the high was $26.25/share (7/31/89) and the low was $18.375/share (5/31/89). *See* Appendix A, lines 8-13.

acquisition of ASC, Marietta common stock rose to heights of $27.25/share, before plummeting to depths as low as $5.00/share.[21]

On July 31, 1989, Rowe purchased 20,400 shares of registered, unrestricted Marietta common stock (hereinafter, the "open market shares") for an average price of $25.93, spending in the aggregate $529,000. On November 6, 1989, Marietta made a secondary offering of shares, selling in excess of one million shares at $20.25/share. Within the same offering, Nadolski sold approximately one-quarter of his capital stock holdings in Marietta. Aggregating the overallotment, less discounts to the underwriters, Marietta netted approximately $22,287,000 from the offering, while Nadolski netted approximately $1,906,000, before taxes. The market not only absorbed this influx of new securities with no immediately discernible negative reaction vis-à-vis the price of Marietta stock, but actually valued Marietta higher after the offering.[22]

Marietta continued to report increasing profits and sales. On February 15, 1990, Marietta issued a release stating that net sales and net income for the first quarter of fiscal 1990 had risen 93% and 45%, respectively, from the

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[21] *Ibid.*, lines 7-30.
[22] *Ibid.*, line 14.

first quarter of fiscal 1989. On May 15, 1990, Marietta reported increases of 76% in net sales and 89% in net income from the previous year's quarterly results.

In the latter half of 1990, the demand for amenities products was adversely impacted by the Persian Gulf War. The first public sign of trouble for Marietta came on August 14, 1990. On that day, Marietta issued a press release in which it reported earnings per share of $0.31, down from $0.36 for the same period in fiscal 1989. Upon news of the $0.05 drop in earnings, the market reacted instantly and severely.[23] August 13, 1990 was the last day Marietta stock exceeded the $20.00/share mark.[24]

Marietta stock continued to tumble on the NASDAQ.[25] On November 12, 1990, Marietta reported on the PR Newswire that the company revised its earnings estimates for fiscal 1990, making a downward adjustment of 5-10%. Marietta issued another press release on December 27, 1990 where Marietta reported a $383,647 decline in net income for fiscal 1990, although sales for the year were up 33%. Earnings per share for the period were reported to be $0.71, compared to $1.29 for fiscal 1989, reflecting a $0.58

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[23]$22.75/share (8/13/90) to $18.25/share (8/14/90) -- *see* Appendix A, line 23.

[24]See Appendix A, lines 23-30.

[25]*Ibid.*, lines 23-27.

decrease from the prior year. For the fourth quarter of fiscal 1990, Marietta reported a $756,913 decrease in net sales, a $1,479,723 net loss, and a $0.51 decrease in earnings per share. In subsequent press releases on February 13, 1991, April 30, 1991, and August 13, 1991, Marietta reported continued decreases in net sales, income, and earnings per share. On August 13, 1991, Rowe bought an additional 450 shares of Marietta stock on the open market, at an average price of $7.00/share, for approximately $3,000.

The first express disclosure of possible financial misrepresentations appeared in Marietta's press release of October 31, 1991. The release stated that Marietta had "discovered evidence of possible defalcations of Company funds by a former financial officer aggregating at least $385,000 and of possible misstatements in the Company's financial statements for its 1988 and 1989 fiscal years." On December 19, 1991, Marietta stated in a press release that preliminary audits revealed irregularities in the financial statements for fiscal years 1987-90, and significant overstatements in reported earnings for fiscal years 1988-89. Marietta also revealed that its outside auditor had withdrawn its opinions for fiscal years 1988-90.

On March 3, 1992, Rowe, Nadolski and Marietta entered into an agreement tolling any limitations periods not already expired for any causes of action arising from the revelations of misstatements in Marietta's financials. On

March 18, 1992, Marietta filed three Form 8's with the SEC, amending the 10-K filed for each fiscal year, 1987-89.[26] Subsequently, December 22, 1992, Marietta filed an amended Form 8 for fiscal 1989. These amendments to prior SEC filings revealed for the first time the extent of Marietta's misrepresentations. In toto, Marietta had overstated net income by approximately $1.7 million, or 37%, over the three years in question. Additionally, Marietta had overstated earnings per share by approximately $0.70 during the relevant time period.

DISPOSITION OF THE TRANSACTION SHARES AND THE CONVERTIBLE NOTE

During the period from March 17, 1989 through August 1, 1990, Marietta's stock rose in value approximately 68%,[27] trading in the last month of this period at approximately $25.50/share,[28] almost 80% over its average price during the month following the closing -- $14.38/share.[29] Rowe sold 175,000 of his 350,100 transaction shares between March 17, 1989 and August 1, 1990, for an average price of $23.99/share. Rowe received approximately $4,200,000 on the sale of these 175,000

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[26] *Supra* at p. 11.
[27] *See* Appendix A, lines 7-23a. *"Ibid.'*, lines 22-23a.
[28] *Ibid.*, lines 22-23a.
[29] *Ibid.*, line 7.

transaction shares. On March 7, 1991, Rowe sold the convertible note to Marietta for $1,600,000. Between March 17, 1989 and March 7, 1991, he had received four interest payments of $94,500 each, for an aggregate $387,000, on the convertible note. Between June 20 and October 3, 1991, Rowe sold another 100, 100 transaction shares, for an average net price of $5.78/share. For these 100,100 transaction shares, Rowe received approximately $579,000. In forced collateral sales on May 1 and May 12, 1992, Rowe sold the remaining 75,000 transaction shares, for an average net price of $4.52/share. Rowe received approximately $340,000 on the disposition of the last 75,000 transaction shares.

DISPOSITION OF OPEN MARKET SHARES

Of the 20,400 open market shares bought on July 31, 1989, Rowe sold 13,800 on December 26, 1990 for an average price of $5.40/share, recovering approximately $74,520. He sold 6,200 shares on January 22, 1991, for an average price of $5.40/share, recovering approximately $33,480. On the disposition of these 20,000 open market shares, Rowe lost approximately $410,000.

On March 12, 1992, Rowe sold the remaining 400 shares purchased on the open market on July 31, 1989, at an average price of $4.07/share, for $1,626. Rowe lost approximately $8,750 on this sale. Finally, also on March

12, 1992, Rowe sold all 450 of the shares he had purchased on the open market on August 13, 1991. This last sale netted Rowe $1,863, or $4.14/share. Rowe lost approximately $1,900 on this final disposition. All told, Rowe lost approximately $420,640 on the open market transactions -- $410,600 of which loss was realized prior to the October 31, 1991 announcement of possible defalcations and financial misstatements, and $10,040 of which was realized after the October 31, 1991 announcement.

THE CLAIMS AT ISSUE

As earlier stated, Rowe alleged two distinct areas of damage in his complaint, to-wit, that he was damaged by reliance on the defendants' fraudulent misrepresentations 1) in signing the March 17, 1989 closing documents, and 2) in subsequent transactions of Marietta stock. Thus the issues before the Court at trial were whether Marietta and co-defendant John Nadolski:

1) Violated 15 U.S.C. §§ 78j(b) and 78t(a) and 17 C.F.R. § 240.10b-5, by making untrue statements or omissions of material fact to Rowe, or by practicing fraud or deceit upon Rowe, in connection with the purchase or sale of securities.

2) Engaged in common law fraud to induce Rowe to sell to Marietta his interest in ASC and to purchase

shares of Marietta common stock on the open market.

CHOICE OF LAW FOR COMMON LAW FRAUD CLAIM

With respect to the common law fraud claim, the Court must apply the choice of law rules of the forum state, Tennessee. Klaxon Co. Stentor Elec. Mfg. Co., Inc., 313 U.S. 487 (1941). For tort claims, Tennessee has adopted the "most significant relationship" approach found in § 145 of the Restatement (Second) of Conflict of Laws (1971) (Restatement). Hataway v. McKinley, 830 S.W.2d 53,59 (Tenn. 1992). Under that four-part approach, the Court looks to:

(a) where the injury occurred;
(b) where the conduct causing the injury occurred;
(c) where the parties reside, are incorporated, and do business; and,
(d) where the relationship between the parties is centered.

Id.

The Court also looks to § 148 of the Restatement, which specifically addresses fraud and misrepresentation. Section 148 guides the Court to inquire:

(a) where the plaintiff acted in reliance;

(b) where the representations were received;
(c) where the representations were made;
(d) where the parties resided or were incorporated; and,
(e) where performance was to be rendered under a contract the plaintiff was induced to enter.

In two prior orders in this case, one dismissing the negligent misrepresentation claim against the defendants and the other denying Rowe's motion for summary judgment, the Court concluded that New York law should apply. Following the same logic, the Court concludes that the underlying facts with respect to Rowe's common law fraud claim are most significantly related to New York -- therefore, New York law applies.

STATUTE OF LIMITATIONS DEFENSE

The defendants have raised the affirmative defense that the applicable limitations period bars Rowe's § 10(b) claim, in whole or in part. In its order of January 29, 1997, the Court held that the applicable limitations period for a private right of action under § 10(b) was "one year from the time the fraud was discovered or should have been discovered." See Lampf, Pleva, Lipkind, Prupis & Petigro v. Gilbertson, 501 U.S. 350, 111 S. Ct. 2773, 115 L. Ed. 2d 321 (1991); Ockerman v. May Zima & Co., 27 F.3d 1151, 1155 (6th Cir. 1994); Dodds v. Cigna Sec., Inc., 12 F.3d 346 (2nd Cir. 1993), cert. denied, 114 S. Ct. 1401 (1994); Chance v. F. N. Wolf & Co., Inc., No. 93-2390, 1994 WL 529901 (4th Cir. Sept. 30, 1994); Topalian v. Ehrma , 954 F.2d

1125 (5th Cir.), cert. denied, 506 U.S. 825 (1992); LaSalle v. Medco Research, Inc., 54 F.3d 443 (7th Cir. 1995); Anixter v. Home-Stake Prod. Co., 939 F.2d 1420, reh'g granted in part, 947 F.2d 897 (10th Cir. 1991), vacated on other grounds sub nom. Denriler v. Trippe, 503 U.S. 979 (1992).

The Court must apply federal law to determine the date on which a statute of limitations in a federal securities case begins to run. Freeman v. Laventhol & Horwath, 34 F.3d 333, 341 (6th Cir. 1994) (citing Holmberg v. Armbrecht, 327 U.S. 392, 66 S. Ct. 582, 90 L. Ed. 743 (1946)); Herm v. Stafford, 663 F.2d 669, 682 (6th Cir. 1989). As Herm instructs, "[t]he Sixth Circuit requires an investor to exercise reasonable care in discovering the alleged fraud." 663 F.2d at 682. Under this "reasonable care" or "reasonable diligence" standard, the plaintiff is assumed to be reasonably intelligent. Id.; Gaudin v. KDI Corp., 576 F.2d 708, 713 (6th Cir. 1978). In Hamer v. Prudential Sec., Inc., 785 F. Supp. 626 (E.D. Mich. 1992), aff'd, 35 F.3d 565 (6th Cir. 1994) (Table), the district court eloquently articulated the "reasonable investor" standard:

> The sophisticated stock broker and the uninitiated rube will both be judged by thesame standard, i.e. the "reasonable investor" standard.

Id. at 634.

Because Rowe, Nadolski and Marietta entered into a tolling agreement on March 3, 1992, the burden on the defendants at trial was to show that Rowe was put on inquiry notice of the alleged fraud prior to March 3, 1991. See Ockerman, 27 F.3d at 1155. On the totality of the facts adduced at trial, the Court finds that the defendants have failed to carry the burden of proving that Rowe knew or should have known of the alleged fraud prior to March 3, 1991. The Court finds that the first express public disclosure of the possibility of fraud on Marietta's books also serves as the first "storm warning" sufficient to constitute constructive notice of the possibility of fraud. See Hamer v. Prudential-Bache, 1994 WL 494871 (6th Cir. 1994). As the first express public disclosure of the possibility of fraud on Marietta's books was the October 31, 1991 press release, the Lampf limitations period did not expire until October 31, 1992, several months after Rowe, Nadolski and Marietta entered into a tolling agreement. Therefore, Rowe's federal fraud claim is not barred by the applicable one-year limitations period.[30]

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[30]The statute of limitations is not a concern in this case with respect to Rowe's common law fraud claim, because New York provides a six year limitations period for fraud. *New York Civil Law & Rules § 213.*

THE ELEMENTS OF FRAUD

Section 10(b), known as the general anti-fraud provision of the 1934 Act, reads in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange ... (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1988). Pursuant to its authority, the SEC has promulgated Rule 10b-5, which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light

> of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C. F. R. §240.10b-5 (1993). In order to establish a primary violation under §10(b) and Rule 10b-5, the plaintiff must prove, by a preponderance of the evidence, as to each of the defendants, each of the following five elements:

1) that in connection with the purchase or sale of a security the defendant either (a) employed a device, scheme, or artifice to defraud; (b) made an untrue statement of material fact or failed to state a material fact that was necessary to prevent the statements that were made from being misleading under the circumstances; or (c) engaged in an act, practice, or course of business that operated as a fraud or deceit upon the plaintiff;

2) that the defendant made the material misrepresentation with scienter;

3) that the plaintiff justifiably relied on the material misrepresentation;

4) that the defendant used an instrumentality of interstate commerce in connection with the purchase or sale of securities to the plaintiff; and,

5) that the plaintiff suffered actual damages as a result of the defendant's conduct.

See Herman & MacLean v. Huddleston, 459 U.S. 375, 103 S. Ct. 683, 74 L. Ed. 2d 548 (1983); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976); Stone, 8 F.3d 1079; Aschinger v. Columbus Showcase Co., 934 F.2d 1402 (6th Cir. 1991); ABA Section of Litigation, Subcommittee on Accounting Issues, Model Jury Instructions (1996); ABA Securities Committee, Subcommittee on Public Offering Litigation, Model Jury Instructions (1986). The elements of New York common law fraud are nearly identical to those of § 10(b) and Rule 10b-5. Banque Franco-Hellenigue de Commerce v. Christophides, 106 F.3d 22, 25 (2nd Cir. 1997). The four elements of a successful fraud claim under New York law are:

1) that the defendant made a materially false representation;
2) that the material misrepresentation was made with the intent to defraud;
3) that the plaintiff reasonably relied on the material misrepresentation; and,
4) that the material misrepresentation was the proximate cause of the plaintiff's monetary damages.

Katara v. D.E. Jones Commodities, Inc., 835 F.2d 966, 970-71 (2nd Cir. 1987).

There are three relevant differences between federal and common law fraud. First, the claimant of common law fraud bears the burden of proving all the elements by clear and convincing evidence, whereas the plaintiff's burden under § 10(b) is proof by a preponderance of the evidence. See, e.g., Ajax Hardware Mfg. v. Industrial Plants Corp., 569 F.2d 181, 186 (2nd Cir. 1977); Richardson Greenshields Sec., Inc. v. Lau, 819 F. Supp. 1246, 1264 (S.D. N.Y. 1993) (in order to prove fraud under New York law, the plaintiff must meet a high standard -- every element of fraud must be proved by clear and convincing evidence as to each defendant); Abrahami v. UPC Constr. Co., 638 N.Y.S.2d 11, 13 (1st Dep't 1996) ("...the burden of proving fraud at trial is one of clear and convincing evidence, and not mere preponderance."). Second, the common law fraud claimant does not need to satisfy the interstate commerce element. Katara, 835 F.2d at 970-71. The third difference arises under the burden of establishing reasonable reliance. The Court will address the differences relating to the reliance element, infra.[31]

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[31]Actions under § 10(b) and Rule 10b-5 are in part designed to expand upon the protections provided to investors by the common law. *Basic, Inc. v. Levinson,* 485 U.S. 224, 244 n.22, 108 S. Ct. 978, 990 n.22, 99 L. Ed. 2d 194 (1988) (citing *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 744-4.), 95 S. Ct. 1917, 1929-30, 44 L. Ed. 2d 539 (1975); *Herman & MacLean,* 459 U.S. at 388-89, 103 S. Ct. at 690-91).

MISREPRESENTATION, MATERIALITY, SCIENTER, AND INTERSTATE COMMERCE

In its order of October 7, 1996 denying Rowe's motion for summary judgment on the common law fraud claim, the Court found that Nadolski's conviction on four counts of securities fraud served, clearly and convincingly, to establish the first and second prongs of the § 10(b) and Katara tests vis-à-vis the individual defendant -- that he made material misrepresentations with scienter. Moreover, based on the clear and convincing weight of the evidence at trial, the Court finds that Nadolski's material misrepresentations date as far back as December 30, 1987, when Marietta filed with the SEC a misstated Form 10-K for fiscal 1987.

Applying the law of agency, the Court then determined in its order of October 7, 1996 that Marietta also made material misrepresentations with scienter, because in this case the agent's scienter is properly imputed to the employer. Cf. Connors v. Lexington Ins. Co., 666 F. Supp. 434, 446 (E.D.N.Y. 1987); Alexander v. Evans, 1993 WL 427409, at *11-12 (S.D.N.Y. Oct. 15, 1993).

After considering all of the evidence at trial, the Court adopts and incorporates its earlier logic and finds, by clear and convincing evidence, that the defendants made material misrepresentations with the requisite scienter, as

early as December 30, 1987, and that the defendants made knowing and material misrepresentations until October 31, 1991. Therefore, the Court finds that Rowe has satisfied the first and second prongs of the § 10(b) and Katara tests.[32] As Rowe's common law fraud claim needs no showing of interstate commerce,[33] the Court will proceed to the issue of reliance.

RELIANCE

In cases of fraud in connection with the purchase or sale of securities traded on an active, open and well-developed market which rapidly reflects new information in price, the plaintiff is entitled to a rebuttable presumption of reliance supported by the efficient capital markets, or fraud-on-the-market, theory. Basic, 485 U.S. at 250, 108 S. Ct. at 993. "Because most publicly available information is reflected in market price, an investor's reliance on any material misrepresentations, therefore, may be presumed for purposes of a Rule l0b-5 action." Id. at 247, 108 S. Ct. at 992; accord Ronald J. Gilson, The Law and Finance of Corporate Acquisitions (1988); Brad M. Barber, Paul A. Griffin & Baruch Lev, The Fraud-On-The-Market Theory

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[32]The parties have stipulated that instrumentalities of interstate commerce were used in connection with the purchase or sale of securities to the plaintiff. Accordingly, the Court finds the fourth element of Rowe's §10(b) claim met.

[33]*See* discussion at p.26, *supra*.

and the Indicators of Common Stocks' Efficiency, 19 J. Corp. L. 285, 286-87 (1994);.

Under the fraud-on-the-market theory, the presumption of reliance rests on two premises. First, the materiality of the misrepresentation must be established by showing that the reasonable investor would place enough significance on the withheld or misstated information to base his investing decision, in part, on that. Id. at 239-40, 108 S. Ct. at 987-88. Second, the Court relies on the premise that, in an open and developed market, "the dissemination of material misrepresentations or the withholding of material information typically affects the price of the stock, and purchasers generally rely on the price of the stock as a reflection of its value." Id. at 244-45, 108 S. Ct. at 990 (quoting Peil v. Speiser, 806 F.2d 1154, 1161 (3rd Cir.), reh'g and reh'g en banc denied (1986)). Of the latter premise, "[t]he same causal nexus can be adequately established indirectly, by proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock." Id. (quoting Blackie v. Barrack, 524 F.2d 891, 908 (9th Cir. 1976), cert. denied, 429 U.S. 816, 97 S. Ct. 57, 50 L. Ed. 2d 75 (1976).

The defendants may rebut the presumption of market reliance by showing 1) that the misrepresentation was immaterial, or 2) that the plaintiff would have undertaken

the acquisition transaction and subsequent open market purchases even if he had known the truth underlying the misrepresentation. See Zlotnick v. Tie Communications, 836 F.2d 818, 821-22 (3rd Cir. 1988); see also Blackie, 524 F.2d at 90 & n.22 (in establishing prima facie case of causation, court looked to elements of reliance, noting "materiality directly establishes causation more likely than not, and that reliance as a separate requirement is simply a milepost on the road to causation'). In order to rebut the fraud-on-the-market presumption of reliance, the defendants' burden is one of the preponderance of the evidence. Blackie, 524 F.2d at 96 & n.22.

In this case, however, the defendants' concede that the misrepresentations were material, and there is no evidence in the record from which the Court could draw a reasonable inference that Rowe would have undertaken to sign the closing documents on March 17, 1989 had he known of the fraud. The defendants have failed to rebut the fraud-on-the-market presumption relative to the open market purchases, and the Court finds that Rowe has satisfied the reliance element of the §10(b) test.

The presumption of reliance found in the fraud-on-the-market theory in actions brought under federal statutes is unavailable to claimants under common law. See e.g., Antonson v. Robertson, 141 F.R.D. 501, 508 (E.D. Kan. 1991); In re One Bancorp Sec. Litig., 136 F.R.D. 526, 532-

33 (D. Me. 1991); Squitieri v. Gould, 133 F.R.D. 25, 27-28 (E.D. Pa. 1990); Deutschman v. Beneficial Com., 132 F.R.D. 359 (D. Del. 1990); Katz v. Comdisco, Inc., 117 F.R.D. 403, 412 (N.D. Ill. 1987); Beebe v. Pacific Realty Trust, 99 F.R.D. 60, 71 (D. Ore. 1983). With regard to Rowe's showing of reliance under the New York common law fraud claim, the defendants maintained at trial that the essential terms of the acquisition were set out and agreed upon as early as October of 1988, and commemorated by a letter of intent signed by Rowe on December 22, 1988, well before February 14, 1989, the earliest date of criminal misrepresentation in the Nadolski conviction. The defendants assert that Rowe did not prove clearly and convincingly that he relied on the misrepresentations prior to entering into the sale of ASC to Marietta: 1) because the record reflects that terms of the acquisition, as they appeared on March 17, 1987, were virtually identical to the terms agreed upon in the December 22, 1988 letter of intent; 2) because the majority of Rowe's expected consideration was not subject to the effect of the fraud; and, 3) because Rowe's only direct evidence of reliance is his self-serving testimony.

The parties were not legally bound to consummate the acquisition until the parties signed the closing documents on March 17, 1989. The Court finds the March 17, 1989 closing date controlling. See 37 Am. Jur. 2d Fraud And Deceit § 241 (1968). Rowe testified at trial that he relied on Nadolski's "on target" assurances given at the meeting of

December 14, 1988, as well as on the financial image of Marietta as reflected in the 1987 and 1988 10-K's, in the February 15, 1989 press release claiming an extra million dollars in sales and in the 10-Q filed on February 14, 1989. Moreover, the Court concludes that the stock portion of the consideration paid Rowe for his 90% interest in ASC was not insignificant. Based on the totality of the facts and circumstances in this case, the Court finds that Rowe had the right to rely on the representations of the defendants to the extent that he did. The Court finds, by virtue of clear and convincing evidence, that Rowe did rely on the defendants' misrepresentations in his decisions to a) enter into the transaction resulting in the acquisition of ASC by Marietta, and b) to purchase the open market shares.

CAUSATION

In order to satisfy the fifth element of a § 10(b) claim, the plaintiff must prove both transaction and loss causation. Fryling v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 593 F. 2d 736, 744 (6th Cir. 1979). Transaction causation requires proof that the defendant's misstatements or omissions were a substantial contributing factor in the plaintiff's purchase of the securities. Id. The Court has already determined that Rowe relied on the defendants' misrepresentations in his decisions to a) sell his interest in ASC to Marietta for consideration including Marietta common stock, and b) purchase Marietta common stock on the open market. Because the evidence shows that

Rowe intended to accept as partial consideration for his interest in ASC, stock in a dynamic, small cap, growth company (i.e., Marietta in the absence of fraudulent reporting practices), and because the evidence shows that Rowe was eager to invest more in Marietta by virtue of the open market purchases, the Court concludes that Rowe has established the requisite transaction causation, by clear and convincing evidence, with respect to both the acquisition and the open market purchases.

Loss causation, on the other hand, requires proof that the defendant's misstatements or omissions were a substantial contributing factor in the investment's decline in value. Id.; see also 15 U.S.C. § 78u-4(b)(4),[34] Section 101 of the Private Securities Litigation Reform Act of 1995 ("PLSRA"), Pub. L. No. 104-67, § 105, 109 Stat. 737, 756-57 (1995). Alternatively, the plaintiff may establish loss causation by proving that the market price of the stock was inflated as a direct result or a reasonably foreseeable result of the defendant's misstatement or omission. Huddleston v.

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[34] 15 U.S.C. § 78u-4(b)(4) Loss Causation

> In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

Herman & MacLean, 640 F.2d 534, 549 n.25 (5th Cir. Unit A 1981), modified on other grounds, 459 U.S. 375, 103 S. Ct. 683, 74 L. Ed. 2d 548 (1983). Although the plaintiff must demonstrate that the defendant's misrepresentation or omission was a cause of the subsequent decline in the security's price, it is not necessary to prove that it was the sole or exclusive cause of the decline. Currie v. Cayman Resources Corp., 835 F.2d 780 (11th Cir. 1988).

During the time between the acquisition of ASC by Marietta and the November 12, 1992 filing of this suit, and, necessarily, between Rowe's July 31, 1989 purchase of 20,000 open market shares and the December 1990 and January 1991 sales of those shares, several events occurred which impacted the price of Marietta stock. One event stands out as the watershed or benchmark event. On August 14, 1990, Marietta issued a press release reporting a drop in earnings per share to $0.31 for the third quarter of fiscal 1990, compared to $0.36 for the third quarter of fiscal 1989. On that day, Marietta stock dropped from $22.75/share to $18.25/share, a one-day loss of 19.8% of the stock's value.

There are several other notable correlations. For instance, on November 12, 1990, Marietta reported on the PR Newswire that the company revised its earnings estimates for fiscal 1990, making a downward adjustment of 5-10%. Marietta fell $0.50, or 8%, on the NASDAQ that day. Following the December 27, 1990 release, wherein

Marietta reported a declines in net sales, net income, earnings per share, Marietta's price fell $0.25, or 4%. In subsequent press releases of disappointing financial news, on February 13, 1991, April 30, 1991, and August 13, 1991, Marietta's stock price fell $0.50 (7%), rose $0.25 (3%), and fell $0.50 (7%),[35] respectively. On October 31, 1991, Marietta revealed that it had discovered evidence of possible defalcations and misstatements by a financial officer. On that day, the Marietta's price fell $1.125, or approximately 18%. Finally, on December 19, 199 1, when Marietta issued a release confirming the existence of financial irregularities and misstatements during the fiscal years 1987-90, the stock price neither rose nor fell. The $3.75/share price was near the nadir over the entire relevant period, however.

The attribution of an increase or decline in the value of a small cap stock, or even a large cap stock, to a specific event is difficult and, inevitably, imperfect. See Baruch Lev and Meiring de Villiers, Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis, 47 Stan. L. Rev. 7 (1994) (hereinafter, Lev & de Villiers, Stock Price Crashes. The Court must identify market reactions to corrective revelations, while isolating factors unrelated to the fraud. See id.

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[35]$6.75 (8/12/91) to $6.25 (8/13/91).

At trial, Rowe consistently asserted that the August 14, 1990 press release of disappointing quarterly earnings and subsequent bad-news releases prior to the October 31, 1991 revelation of the possibility of fraud and the December 19, 1991 admission of misstatements, served to depress the price of Marietta stock on the market and should be factored into the Court's calculation of the effect of the fraud on the value of the transaction and open market shares. The Court agrees that the calculation of the inflation properly attributable to the fraud is influenced by many factors, not just the market's reaction on October 31, 1990. The Court bases its conclusion on the fact that the defendants caused pre-disclosure losses by fraudulently reporting earnings in the 1987-90 fiscal years. It would work a manifest injustice and run contrary to the remedial intent of the 1934 Act to bind the plaintiff's proof on loss causation and damages only to express disclosure of fraud. Fraudfeasors should not be allowed to minimize potential damages through the gradual dissemination of truthful, dampening results to the market, prior to express disclosure of the underlying fraud. Cf. Wool v. Tandem Computers, Inc., 818 F.2d 1433, 1438 (9th Cir. 1987) ("[W]e conclude that a jury could readily find that the marketplace had assimilated this *information [of* slowing sales growth and declining profitability] and thus diminished the inflation attributable to the alleged fraud."); Blackie, 524 F.2d at 909 n.25 ("[A] drop after a corrective disclosure will not be conclusive of the amount of original inflation, both because the correction may be only partial

[internal parenthetical phrase omitted], and because the prolonged nature of the fraud introduces other market variables which may affect the amount the market reacted to disclosures at different times ...").

The Court finds, by clear and *convincing evidence*, that the collapse[36] in the price of Marietta stock on the NASDAQ was tied to 1) the failure of Marietta to meet prior earnings figure which were artificially inflated due to the defendants' fraud, 2) the revelation of Blair's defalcations and Nadolski's and Blair's financial misstatements, and 3) the effects of the Persian Gulf War, satisfying both the §10(b) and New York common law fraud tests. For the measure of this decline, the Court finds that two dates predominate: August 14, 1990, the date that Marietta released news of income and earnings losses for the first time since going public, and October 31, 1991, the first time Marietta publicly revealed the possibility of fraud on its books.

In order to affix a percentage for the amount of inflation attributable to the fraud, the Court looks to the market's reaction -- in an efficient capital market, supposedly an accurate reflection -- in the 90-day period following each date. Cf. 15 U.S.C. § 78u-4(e)(1) (1995).[37]

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[36] *See* Appendix A, lines 23-27.
[37] *Infra* note 40.

Section 78u-4(e), though not binding on the Court,[38] indicates that the 90-day arithmetic mean stock price following the dissemination of information correcting a misrepresentation or omission is an accurate measure of the amount of inflation attributable to fraud in a case involving the purchase or sale of securities. Cf. id. The results of this application show that:

1) There was a 33.0% negative market reaction precipitated by the October 31, 1991 press release, the first express disclosure of the fraud; and,

2) There was a 59.0% negative market reaction that occurred following the August 14, 1990, the first date Marietta disclosed a decline in net income and earnings per share.

The Court recognizes that other factors unrelated to the defendants' fraud (e.g., the Persian Gulf War) had a negative impact on the market price of Marietta stock over the latter period. See Lev & de Villiers, Stock Price Crashes, 47 Stan. L. Rev. 7. Accordingly, the Court, as the trier of fact in this case, upon review of all the evidence adduced at trial, fixes 40.0% as the applicable measure of the inflation attributable to the fraud.

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[38] *Ibid.*

THE ELEMENTS OF FRAUD - PART TWO

The Court finds, by a preponderance of the evidence, that Rowe has met all the requirements of proving fraud under his § 10(b) claim. See Herman & MacLean, 459 U.S. 375, 103 S. Ct. 683; Ernst, 425 U.S. 185, 96 S. Ct. 1375; Stone, 8 F.3d 1079; Aschinge, 934 F.2d 1402; ABA Section of Litigation, Subcommittee on Accounting Issues, *Model Jury Instructions* (1996); ABA Securities Committee, Subcommittee on Public Offering Litigation, *Model Jury Instructions* (1986).

The Court also finds, by clear and convincing evidence, that Rowe has met all the requirements of proving fraud under his New York common law fraud claim. See Christophides, 106 F.3d 22; Katara, 835 F.2d 966; Ajax, 569 F.2d at 186; Lau, 819 F. Supp. 1246; Abrahami, 638 N.Y.S. 2d11.

The Court's findings pertain only to Rowe's claims as they relate to the transaction and open market shares discussed supra, and in no way apply to other claims Rowe may have articulated in the Second Amended Complaint or its predecessors, or under any other theory posited by Rowe at trial, which other claims or theories, if any, the Court

expressly dismisses as unproven under either applicable standard.[39]

THE APPROPRIATE MEASURE OF DAMAGES

The function of the Court is to fashion the remedy best suited to the harm. Arthur Young & Co. v. Reves, 937 F.2d 1310, 1336 (8th Cir. 1991); Pelletier v. Stuart-James Co., Inc., 863 F.2d 1550, 1558 (11th Cir. 1989); Hackbart v. Holmes, 675 F.2d 107, 111 (10th Cir. 1982); Arrington v. Merrill Lynch, Pierce, Fenner & Smith, 651 F.2d 615,

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[39]The Court enters this admonishment due to the especially convoluted and complex history of this case. At trial, Rowe announced that he was not pursuing recovery based on any part of the total earnout package. Furthermore, Rowe offered no evidence that the disposition of the convertible note was influenced by the defendants' fraud. The Court finds with particularity that, even if Rowe pursued a claim based on the convertible component of the note, recovery under either a § 10(b) or common law fraud theory would be denied for failure to prove the elements of fraud. Rowe held the note for several months during which he had the right to convert the note. The circumstances surrounding the stock component of the convertible note are simply too attenuated for adjudication under a fraud theory, given the facts of this case. Moreover, with regard to Rowe's negligent misrepresentation claim, the Court finds that no special relationship existed between the plaintiff and the defendants, requisite to recovery under New York law. *Accusystems, Inc. v. Honeywell Info. Sys., Inc., 580* F. Supp. *474, 48081* (S.D.N.Y. *1984).* Furthermore, the Court dismissed Rowe's negligent misrepresentation claim in its order of April 11, *1994.* With regard to any breach of contract claims, the Court hereby dismisses them as unproven, in *toto.*

621 (9th Cir. 1981); Osofsky v. Zir), 645 F.2d 1114, 1121 (2nd Cir. 1981); Blackie, 524 F.2d at 909; Gottlieb v. Sandia Am. Corv., 452 F.2d 510, 516 (3rd Cir.), cert. denied, 404 U.S. 938, 92 S. Ct. 274, 30 L. Ed. 2d 250 (1971). The Court has several available options for the computation of damages on the §10(b) claim.[40]

The most widely used method for computing damages in a § 10(b) case is the "out of pocket" approach. Stone v. Kirk, 8 F.3d 1079, 1092 (6th Cir. 1993). Stone, a leading Sixth Circuit case on § 10(b) damages, indicates:

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[40]In the PSLRA, Congress added a limitation-on-damages provision applicable to claimants under private right in false or misleading statement or omission cases (e.g., § 10(b) and Rule 10b-5). This provision, codified at 15 U.S.C. § 78u-4(e)(1), limits recovery to "the difference between "the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market." Congress expressly provided that § 78u-4 did not affect or apply to any private action commenced prior to the December 22, 1995 effective date of the amendment. See 15 U.S.C. § 78u-4, Historical and Statutory Notes, Effective Date. As the case *sub judice* relates to a complaint filed on November 12, 1992, the PSLRA amendment found at 15 U.S.C. § 78u-4(e) does not bind this Court. The Court is persuaded, however, that Congress intended §78u-4(e) to militate in favor of the application of the "out of pocket" rule to private § 10(b) and Rule 10b-5 cases, and will weigh Congress' intent among other relevant considerations.

> The correct measure of damages in cases arising under § 10(b)/Rule l0b-5 is generally held to be an "out of pocket" measure. By this is meant "the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct."

8 F3d at 1092 (citing Randall v. Loftsgaarden, 478 U.S. 647, 661-62, 106 S. Ct. 3143, 3152, 92 L. Ed. 2d 525 (1986) (quoting Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155, 92 S. Ct. 1456, 1473, 31 L. Ed. 2d 741 (1972))). The Sixth Circuit Court of Appeals has also defined "out of pocket" damages in the market reliance context, holding that "[u]nder Section 10(b), the level of damages is usually the difference in price that the investor paid based on the false and misleading statements and the price that the stock would have sold at had the market been aware of the truth." Mayer v. Mylod, 988 F.2d 635, 640 (6th Cir. 1993) (citing Affiliated Ute Citizens, 406 U.S. at 155, 92 S. Ct. at 1473); Glick v. Campagna, 613 F.2d 31, 36 (3rd Cir. 1980); Dupuy v. Dupuy, 551 F.2d 1005, 1024-25 (5th Cir. 1977)); see also Pelletier, 863 F.2d at 1557; In re Seagate Tech. II Sec. Litig., 843 F. Supp. 1341, 1347 (N.D. Cal. 1994). Under the standard "out of pocket" approach, the Court would then deduct whatever profits may have accrued to the plaintiff in his disposition of the subject shares. Blackie, 524 F.2d at 908-09; Ballan v. Upjohn Co., 159 F.R.D. 473, 483 (W.D. Mich. 1994); In re Seagate,

843 F. Supp. at 1347-50; Katz v. Comdisco, Inc., 117 F.R.D. 403, 407-08 (N.D. 111. 1987).

In the case at bar, application of the "out of pocket" approach would cause the Court to consider the value of Rowe's 90% interest in ASC on March 17, 1989, less the four non-stock components of the consideration received by Rowe, as the price that the investor (Rowe) "paid" for the fifth component -- the transaction shares in Marietta. The Court would then evaluate the true worth of the transaction shares as of March 17, 1989, had the fraud been known to the investing public at the time. From the remainder, if any, the Court would deduct any profit Rowe received in selling the transaction shares for inflated prices. Assuming there is a positive balance at the end of the computation, this balance would represent Rowe's damages.

However, in two leading cases, the Supreme Court has departed from the traditional "out of pocket" rule in order to arrive at remedies deemed more appropriate to the particular circumstances of the case. Exercising its broad discretion, the Court in Affiliated Ute Citizens, supra, articulated a standard applicable to the measurement of damages under § 28 of the 1934 Act, 15 U.S.C. § 78bb(a), to-wit:

> In our view, the correct measure of damages is the difference between the fair value of all that the [plaintiff] received and the fair value

> of what he would have received had there been no fraudulent conduct, except for the situation where the defendant received more than the [plaintiff's] actual loss. In the latter case damages are the amount of the defendant's profit.

406 U.S. at 155, 92 S. Ct. at 1473 (citations omitted). The Affiliated Ute Citizens Court premised its decision on its reading of wide latitude, vis-i-vis remedial measures, into the philosophy and intent behind the 1934 Act:

> [T]he 1934 Act [15 U.S.C. §§ 78a, et seq.] and its companion legislative enactments [e.g., 1933 Act, 15 U.S.C. §§ 77a, et seq.] embrace a "fundamental - purpose. . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186, 84 S. Ct. 275, 280, 11 L. Ed. 2d 237 (1963). In the case just cited the Court noted that Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." Id. at 195, 84 S. Ct. at

285. This was recently said once again in Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12, 92 S. Ct. 165, 169, 30 L. Ed. 2d 128 (1971).

Affiliated Ute Citizens, 406 U.S. at 151, 92 S. Ct. at 1471.

In Randall, the Supreme Court went one step further, ratifying the retention of certain "windfall" profits by the defrauded party, if necessary to prevent the unjust enrichment of the fraudfeasor. The Court opined:

> [T]his Court has never interpreted § 28(a) as imposing a rigid requirement that every recovery on an express or implied right of action under the 1934 Act must be limited to the net economic harm suffered by the plaintiff. To be sure, this Court has noted that "Section 28(a) of the 1934 Act ... limits recovery in any private damages action brought under the 1934 Act to 'actual damages,'" Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 734, 95 S. Ct. 1917, 1925, 44 L. Ed. 2d 539 (1975), and Affiliated Ute Citizens clearly interpreted § 28(a) as governing the measures of damages that are permissible under § 10(b). 406 U.S. at 155, 92 S. Ct. at 1473. But the Court in

> Affiliated Ute Citizens also indicated that "where the defendant received more than the seller's actual loss ... damages are the amount of the defendant's profit." Ibid. This alternative standard aims at preventing the unjust enrichment of a fraudulent buyer, and it clearly does more than simply make the plaintiff whole for the economic loss proximately caused by the buyer's fraud. Indeed, the accepted rationale underlying this alternative is simply that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." Janigan v. Taylor, 344 F.--)d 781, 786 (lst Cir.), cert. denied, 382 U.S. 879, 86 S. Ct. 163, 15 L. Ed. 2d 120 (1965). See also Falk v. Hoffman, 233 N.Y. 199, 135 N.E. 24i (1922) (Cardozo, J.). Thus, the mere fact that the receipt of tax benefits, plus a full recovery under a rescissory measure of damages, may place plaintiff in a better position than he would have been in absent the fraud, does not establish that the flexible limits of § 28(a) have been exceeded.

478 U.S. at 663, 106 S. Ct. at 3153.

The line of cases following Affiliated Ute Citizens and Randall can be divided into three main categories: 1) rescission, 2) restitution, and 3) expectancy, as well as several hybrid subcategories. Under the rescissory approach, which is the measure mandated for violations of § 12(2) of the 1933 Act, the prevailing plaintiff is entitled to "the consideration paid for [the] security with interest thereon, less the amount of any income received thereon ...." 15 U.S.C. § 771; Lee Stone, 8 F.3d at 1092. The rescissory approach necessitates an undoing of the sale of ASC to Marietta. Of course, truly rescinding the sale ten years after the fact is a practical impossibility. Therefore, under the rescissory approach, the Court would order the return to Rowe of an amount representing 90% of the value of ASC at the time of the transaction, less the aggregate value Rowe received in consideration therefor.

Restitution is a tort damage measure against unjust enrichment, which entitles the prevailing plaintiff to recover the amount by which the fraudfeasor benefited from his fraud. See Robert B. Thompson, The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages, 37 Vand. L. R. 349, 370-71 (March 1984) (hereinafter, Thompson, Restitution Alternative). Under the restitution approach, the Court would compute Rowe's damages by adding the product of the rescissory method to any profit received by the defendants proximate to the

transaction, above and beyond the product of rescission. The sum total would represent Rowe's damages.

The expectancy approach, often called the "benefit of the bargain" rule, is contractual in nature, and has received little support over the years. See Thompson, Restitution Alternative, 37 Vand. L. R. at 359-60. There are two primary reasons that the expectancy approach has not been favored. First, in Smith v. Bolles, 132 U.S. 125 (1889), the Supreme Court refused to allow a defrauded purchaser of stock the "fruits of an unrealized expectation." Id. at 130. Some courts have read this to exclude recovery of the benefit of the bargain in a case brought under § 10(b). See, eg., Janigan v. Taylor, 344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 125 (1965). The other reason posited by some courts for refusing to apply an expectancy measure of damages to securities fraud case is a constrictive reading of § 28(a)'s "actual damages" provision. As noted supra, Randall effectively eliminated this latter basis of reluctance, in favor of an interpretation of § 28(a) with latitude commensurate with the remedial nature of the 1934 Act. 478 U.S. at 663, 106 S. Ct. at 3153; see also Hackbart, 675 F.2d 1114; Osofsky, 645 F.2d at 111 ("actual damages" limitation of § 28 intended to prohibit double recovery and punitive damages, not expectancy damages) (relying on J.I. Case Co. v. Borak, 377 U.S. 426 (1964)); Joan M. Hall and Sophia R. Papandreas, Measuring Damages in Securities Litigation, 492 PLI/Corp. 357 (1985).

The authority for expectancy damages under a fraud theory is strongest in a contractual or quasi-contractual setting. See Restatement (Second) of Torts §549(2) (recipient of a fraudulent misrepresentation in a business transaction also entitled to recover additional damages sufficient to give him the benefit of his contract with the maker, if these damages are proved with reasonable certainty). Fraudulent inducement is an economic tort which, in the interests it seeks to protect, more closely resembles principles of contract than principles of tort. Thompson. Restitution Altemative, 37 Vand. L. R. at 358 (citing W. Prosser, Law of Torts §110 (4th ed. 1973); D. Dobbs, Handbook on the Law of Remedies § 9.2 (1973)). The major element of this case arises from a contract for the acquisition of Rowe's ASC capital stock by Marietta, for consideration. Presuming that the expectancy approach is appropriate, the Court would quantify Rowe's reasonable expectations and award him the difference between his reasonable expectations and the consideration realized in the transaction.

It must be noted, though, that expectancy damages are awarded only where the amount can be computed with certainty. Barrow v. Forest Lab., Inc., 742 F.2d 54, 59 (2nd Cir. 1984). The Court will neither supply terms by hypothesis nor try to guess what the parties would have done had the circumstances surrounding the transaction been different. See id.

In this case, the Court concludes that the "out of pocket" approach is the most appropriate remedy for Rowe's federal claim. See Clark v. John Lamula Investors, Inc., 583 F.2d 594 (2nd cir. 1977); Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2nd Cir. 1970); Gamatz v. Stifel, Nicolaus & Co., 559 F.2d 1357 (8th Cir. 1977), cert. denied, 435 U.S. 951 (1978); Feldman v. Pioneer Petroleum, 813 F.2d 296 (10th Cir.), cert. denied, 484 U.S. 954 (1987); Chelsea Assocs. v. Rapanos, 376 F. Supp. 929 (E.D. Mich. 1974), aff d, 527 F.2d 1266 (1975); see also Affiliated Ute Citizens, 406 U.S. at 151, 92 S. Ct. at 1471; Stone, 8 F.3d at 1092; Reves, 937 F.2d at 1336; Pelletier, 863 F.2d at 1558; Hackbart, 675 F.2d at 111; Arrinton, 651 F.2d at 621; Osofsky, 645 F.2d at 1121; Blackie, 524 F.2d at 909; Gottlieb, 452 F.2d at 516.

With respect to Rowe's common law fraud claim, New York has several theories akin to the federal common law. The normal measure of damages utilized by New York courts under a New York common law fraud theory is the "out of pocket" measure, as articulated by De Vaughn v. Frank E. McGray Co., Inc.:

> The purpose of an action for deceit is to indemnifY the party injured. All elements of profit are excluded. The true measure of damages is indemnity for the actual pecuniary loss sustained as the direct result

> of the wrong. The plaintiff paid $5,000 for the stock purchased by him. If he were entitled to recover at all, it was the difference between that amount and the value of the stock which he received, with interest from that time. He was not entitled to anything else. This is the rule, not only in this state, but in the federal courts.

226 N.Y.S. 474, 476 (N.Y. App. Div. 1928) (citation omitted); accord Erbe v. Lincoln Rochester Trust Co., 151 N.Y.S.2d 56, 76 (N.Y. Sup. Ct. 1956) ("In an action at law for damages resulting from fraud all elements of profit are excluded. "); Smith v. Happiness Candy Stores, Inc., 40 N.Y.S.2d 382, 384 (N.Y. Sup. Ct. 1943) (correct measure of damages held to be difference between sales price and market value at time of transaction).

In this case, with respect to Rowe's state claim and for the same reasons as articulated vis-A-vis the federal claim, supra, the Court concludes that the "out of pocket" approach is the most appropriate remedy. See Vaughn, 226 N.Y.S. at 476; Smith, 40 N.Y.S.2d at 384; see also Allen v. Westpoint-Pepperell, Inc., 908 F. Supp. 1209 (S.D.N.Y. 1995).

When a federal securities claim overlaps with a pendant state law claim, the plaintiff is entitled to the

maximum amount recoverable under any claim. Grogan, 806 F.2d at 839 (citing Jacobs, The Measure of Damages in Rule 10b-5 Claims, 65 Geo. L. J. 1093, 1166 (1977) (hereinafter, Jacobs, The Measure of Damages)). The Court finds that New York law would not compensate Rowe more than would the federal law under any theory of computing actual damages. See Vaughn, 226 N.Y.S. at 476; Smith, 40 N.Y.S.2d at 384. The federal "out of pocket" approach offers the Court more latitude, Basic, 485 U.S. at 244 n.22, 108 S. Ct. at 990 n.22,[41] and, presumably, a greater recovery than application of the New York approach as articulated under Vaughn or Smith, supra. Therefore, it is the Court's conclusion that the federal "out of pocket" approach is the more appropriate remedy and will be applied to determine Rowe's compensatory damages, if any.

Punitive damages are not permitted in private actions under § 10(b). Stone, 8 F.3d at 1093; Grogan v. Garner, 806 F.2d 829, 838 (8th Cir. 1986). However, the foregoing proscription of punitive damages on a § 10(b) claim does not prohibit the award of punitive damages on pendant state claims, provided that applicable state law permits such damages. Grogan, 806 F.2d at 838 (citing Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189, 1200 (8th Cir. 1978); Ryan v. Foster & Marshall, Inc., 556 F.2d 460, 464

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[41] *See* discussion *supra* at note 31.

(9th Cir. 1977); Falks v. Koegel, 504 F.2d 702, 706-07 (2nd Cir. 1974); Coffee v. Permian Corp., 474 F.2d 1040, 1044 (5th Cir.), cert. denied, 412 U.S. 920, 93 S. Ct. 2736, 37 L. Ed. 2d 146 (1973); Young v. Taylor, 466 F.2d 1329, 1337 (10th Cir. 1972)).

Unlike punitive damages, prejudgment interest in a § 10(b) claim is permitted and is within the sound discretion of the trial court. Grogan, 806 F.2d at 838 (citing Blau v. Lehman, 368 U.S. 403, 414, 82 S. Ct. 451, 457, 7 L. Ed. 2d 403 (1963); Woods v. Barnett Bank, 765 F.2d 1004, 1014 (1 lth Cir. 1985)); accord De Vaughn, 226 N.Y.S. at 476 (with relation to state common law claim); Erbe, 151 N.Y.S.2d at 76 (same).

The Court will reserve the application of punitive damages under the state common law theory, and prejudgment interest under either the state or federal claim, until it is established that Rowe is entitled to compensatory damages. First, the Court must determine the value of what Rowe "paid" for the subject securities -- that is, Rowe's 90% interest in ASC.

VALUATION OF ASC

Douglas Southard, a certified public accountant and chartered financial analyst, testified as an expert witness to the value of ASC at the time of acquisition. The Court notes that Southard had no previous experience valuing a soap

company prior to ASC, nor had Southard ever testified as an expert in a federal court in a lOb-5 securities fraud case, before this trial.

Southard opined that the value of ASC on March 17, 1989 was $19,670,000. Southard based this valuation on the weighted average of six methods of valuation applied to ASC. The table below summarizes Southard's six-method, weighted average calculations:

Valuation Method	Result	Weight	Weighted Result
Asset Based Approach	$11,061,000	10%	$1,106,100
Historical Income Approach	$19,170,000	30%	$5,751,000
Projected Income Approach I (without merger synergy)	$19,148,000	10%	$1,914,800
Projected Income Approach II (with merger synergy)	$25,068,000	10%	$2,506,800
Market Transaction Approach	$19,548,000	10%	$1,954,800
Market Guideline Approach	$21,465,000	30%	$6,439,500
		100%	$19,673,000

Southard calculated that Rowe's 90% share of weighted value of ASC was worth $17,703,000 at the time of the acquisition.[42] Southard applied no discount for lack of marketability to Rowe's 90% share of ASC because Rowe held the majority interest in ASC.

The asset based approach relies on ASC's financial statements, with adjustments made to reflect differences between "going concern" value (the quasi-liquidation value of the asset if sold as part of a going concern), "historical" value (cost) and "book" value (cost less depreciation). Southard valued ASC at $6,230,926 before making upward adjustments of $4,830,074 to reflect his estimation of the market value (i.e., going concern value) of ASC real estate and equipment. Southard testified that he based his valuation of ASC's real estate on a 1989 appraisal, without considering an earlier 1987 appraisal. At trial, there was some contention over whether these two appraisals, which were both moved into evidence, concerned the same property. Further complicating the issue is that, on the cover of the 1987 appraisal appears the notation "1st Draft", and several markings occur within the text of the appraisal to indicate that relevant data addressing the acreage and value of the subject lot should be deleted or amended. Moreover, the improvement listed in the 1987 appraisal is

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[42] $19,673,000 x 0.90 = $17,703,000.

approximately 40,500 square feet, while the 1989 appraisal reflects an improvement of approximately 102,000 square feet, which improvement had an effective age of one year. Having compared the two appraisals, the Court finds that Southard's reliance on the 1989 appraisal is reasonable under the circumstances. Therefore, the Court concludes that Southard's upward adjustment of $1,561,752 to the book value of ASC real estate is not unreasonable.

Southard made an upward adjustment of $3,268,546 to the book value of the equipment, to recognize the inherent value of the assets in the context of a going concern. To rebut Southard's opinions concerning the resale value of the ASC equipment, Marietta called Wallace Bruce, a person who worked 21 years in the soap business, had personal knowledge of the subject equipment, and inspected the subject equipment and relevant servicing records. Bruce was neither offered nor qualified as an expert witness. Bruce testified that ASC's records reflected inadequate maintenance of the equipment between 1986 and 1989, warranting downward adjustment. After considering all of the relevant testimony, however, the Court finds that Marietta failed to effectively rebut Southard's appraisal of the ASC equipment. Thus, the Court finds that Southard's upward adjustment of $3,268,546 is reasonable, and further finds Southard's resultant figure of $11,061,000, under the asset based method of valuation, reasonable.

The historical income approach focuses on the operating margins of the five years prior to 1989. The operating margin is the percentage yielded by dividing the reported net sales for a given year into the reported operating income for the same year. Southard averaged operating margins of 12.75% (1984), 11.17% (1985), 17.29% (1986),[43] 11.59% (1987), and 11.51 % (1988) to compute the historical operating margin of ASC. Arriving at a 12.37% average operating margin, Southard then applied the 12.37% margin to the estimated 1989 net sales figure of $24,925,000, to yield $3,083,223, the anticipated operating income for 1989. After deducting 1989 interest expense ($900,000) and estimated 1989 income taxes ($829,625), Southard arrived at $1,353,598, rounded to $1,350,000, which represents the anticipated 1989 after-tax earnings of ASC.

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[43]In the interest of conservatism, Southard weighted the 1986 operating margin at 1/2 of each of the other annual operating margins, because it was his opinion that the 1986 operating margin was aberrant due to exceptionally favorable conditions that year.

Then Southard calculated the capitalization factor, a multiplier to compute the value of ASC under the historical income approach. To arrive at the capitalization factor, Southard used the following formula:

$$\frac{1.0}{r - 9}$$[44]

Southard used 21.5 % as "r" (long-term government bond rate of 9.1 %, plus 12.4% as the small cap stock premium, minus 0% risk premium) and 12% as "g". Accordingly, the resulting capitalization factor, derived on a minority interest in ASC, is 10-53x. To account for Rowe's majority interest, Southard added a 35% control premium, arriving at 14.20x as the operativecapitalization factor. Multiplying $1,350,000 by 14.20, Southard reached $19,170,000 as the value of ASC on March 19, 1989, under the historical income approach.

Marietta asserts that Southard's opinion hinges on two erroneous assumptions. First, Marietta points out that both Rowe and Holden testified that ASC's anticipated long-range growth rate in the soap business was closer to 10% than to the 12% rate relied upon by Southard.[45] The Court

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[44]"The value "r" equals the hypothetical investors' required rate of return. The value "g" equals the subject company's anticipated rate of growth.

[45]Although Southard's growth rate of 12% and the rate of 10% anticipated by Rowe and Holden are for fundamentally

agrees that Southard's assumption of a 12% growth rate is clearly contradicted by the weight of evidence adduced at trial, and finds a 10% growth rate to be the appropriate rate. Second, Marietta suggests that the control premium of 35% based upon the 1987 Mergerstat Review is inapplicable to a company with annual net sales below $25,000,000 (for 1988, Marietta's reported net sales were $20,530,727). Marietta asserts that a control premium of less than 35% would be more accurate. While this assessment may be correct, Marietta did not offer competent proof to establish another measurement. Under the circumstances, the Court finds that 35% is a reasonable control premium. The Court, therefore, in evaluating Marietta's worth on March 17, 1989, under the historical income method, finds the value of ASC to be $15,854,000.[46]

The projected income approach, without merger synergy, and the projected income approach, with merger synergy, both rely on projections of sales growth. The Court finds the ASC growth projections of Rowe and Holden more

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different types of growth (i.e., reported operating income vs. sales), the Court finds that the relationship between sales and income in the subject industry is so close as to be interchangeable.

[46]$1,350,000 x 11.74 = $15,853,695.65. The capitalization factor of 11.74x is arrived at by substituting 10% (in lieu of 12%) as a value for "g" in the formula below:

$$\frac{1.0}{21.5\% - g} + \text{the 35\% control premium, or } 3.04x = 11.74x$$

credible than those on which Southard's opinion is based.[47] Therefore, the Court replaces Southard's growth rates of 19.57% (1989), 16% (1990), 15.75% (1991), 15.51% (1992), 15.32% (1993), and 5% (1994-98), with a steady growth rate of 10% for 1989-98. The ultimate impact that this change has on Southard's valuations under both the non-synergistic and the synergistic scenarios is reflected in the chart below:[48]

Southard	Projected Income Approach I (without merger synergy)	19,148,000
Court	Projected Income Approach I (without merger synergy)	$13,978,676
Southard	Projected Income Approach II (with merger synergy)	$25,068,000
Court	Projected Income Approach II (with merger synergy)	$20,729,989

The market transaction approach employs the terms of the acquisition, as valued on or immediately after the closing, to arrive at a valuation of ASC. The cash

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[47]Supra note 45.

[48]For a more complete analysis of the derivation of these numbers, the Court has reviewed, and confirmed as accurate, the charts at Appendices B & C of Marietta's post-trial memorandum, which are merely arithmetic calculations based on evidence adduced at trial and provided as an aid to the Court.

component of the deal was liquidated at $5,363,678.[49] For the purposes of Southard's calculations, the $3,000,000 face value, interest-bearing note was given a present value of $2,094,129. There is no disagreement about the value ascribed the note. Southard valued the common stock component of the purchase price at $3,349,290, and that figure is undisputed for the purposes of this valuation. It is undisputed that the non-compete agreement bore consideration in the amount of $1,500,000, which is a liquidated cash value. Southard valued the EBITearnoutat $4,556,111 and the glycerine earnout at $2,684,457, the sum of the total eamout package being $7,240,568. However, Rowe testified at trial that he and Holden estimated the present value of the total earnout package to be approximately $4,000,000[50] on March 17, 1989. Southard admitted on cross-examination that the market transaction approach value would suffer a decrease commensurate with the difference between the Rowe/Holden valuation of the total earnout package and Southard's figures. Substituting the Rowe/Holden eamout estimate for the eamout numbers relied upon by Southard, the Court finds a net decrease to the market transaction method of $3,240,568. Accordingly,

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[49]$6,02 1,000, less contractual adjustments based on the net worth of ASC at closing.

[50]$3,600,000 representing Rowe's 90% share in ASC, and $400,000 representing Holden's 10% share.

the result of the revised market transaction method is $16,307,000.

Finally, Southard employed the market guideline approach. To conduct the market approach using guideline companies, Southard identified similar companies whose stocks are publicly traded. The companies comprising Southard's representative sample include Alfin, Inc.; DEP, Corporation; Guest Supply, Inc.; Marietta; and Neutrogena Corporation. Southard borrowed 1988 "P/E" (price/earnings) multiples from each of the guideline companies in order to compute an average P/E multiple as the base capitalization factor for ASC. Two of the guideline companies were immediately disqualified, to-wit: 1) Guest Supply, because it had negative earnings and therefore a null P/E multiple; and 2) Neutrogena, because its P/E multiple of 27.10x was clearly outside the range of the average P/E ratios of the four guideline companies with positive earnings, which average was 15.63x. With the disqualification of Guest Supply and Neutrogena, Southard was left with Alfm, DEP and Marietta. The computation of a base capitalization factor for ASC based on the 1988 P/E multiples of these three companies yielded an estimated P/E ratio of 11.80x. According to Southard, this 11.80x P/E value represents a minority interest.

Southard made no adjustments compensating for absolute size, market access, diversity of operations and

customers, and payment of dividends, opining that ASC's market position and high level of profitability mitigated any putative grounds for discount. Southard did, however, add a 35% control premium to the average base capitalization factor (11. 80x), to arrive at ASC's formulated P/E multiple of 15.90x.

Multiplying ASC's 1989 estimated after-tax income of $1,350,000 by the P/E multiple of 15.90x, Southard computed ASC's value at the time of the sale as $21,465,000. According to his testimony at trial, however, Southard relied on Marietta's reported earnings per share of $0.80, as of December 31, 1988, earnings which were the product of fraudulent accounting by Marietta's CEO and CFO. Accurate earnings per share ($0.69) would alter the equation averaging the P/E ratios of the three guideline companies, yielding a base capitalization factor of 10.78x and, after computation of the control premium, an average P/E multiple of 14.55x. By multiplying $1,350,000 by the 14.55x average P/E multiple, the value of ASC under the market guideline approach would be $19,644,500. The Court finds that $19,642,500 is the correct value of ASC under the market guideline method.

Substituting the Court's findings for Southard's, and using Southard's weighted valuation method, which the Court finds fundamentally acceptable, the value of ASC on the acquisition date is reflected in the chart below:

Valuation Method	Result[51]	Weight	Weighted Result
Asset Based Approach	$11,061,000	10%	$1,106,100
Historical Income Approach	$15,854,000	30%	$4,756,200
Projected Income Approach I (without merger synergy)	$13,979,000	10%	$1,397,900
Projected Income Approach 11 (with merger synergy)	$20,730,000	10%	$2,073,000
Market Transaction Approach	$16,307,000	10%	$1,630,700
Market Guideline Approach	$19,643,000	30%	$5,892,900
		100%	$16,856,800

Whether to apply a valuation discount to Rowe's controlling share is the final issue for the Court to consider in calculating the value of what Rowe sold on March 17, 1989. Southard testified that he did not apply an illiquidity discount to Rowe's majority share in ASC, His reasons for not doing so were that Rowe's interest in ASC was the controlling interest and that the March 17, 1989 transaction provided liquidity to the holder of the controlling interest.

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[51]Rounded to the nearest thousand.

Shannon Pratt, author of Valuing a Business: The Analysis and Appraisal of Closely Held Companies (3d ed. 1996) (hereinafter, Pratt, Valuing A Business , a treatise recognized by Southard as "one of the best," states:

> Empirical data clearly suggests that valuation discount is appropriate for controlling interests, and for that matter, 100% ownership interests, in closely held businesses. And this lack-of-marketability discount or illiquidity discount applies, although to varying degrees, regardless of whether the subject company is valued by reference to publicly traded guidelines, guideline companies, consummated guideline acquisitions ...

Id. at 357.

Southard, while recognizing Pratt's preeminence in the valuation field, testified that over 90% of the professionals in his field, including Southard, disagreed with Pratt over this point of valuation discount. At trial, Southard indicated that it would not be unreasonable to apply a 5% valuation discount to reflect transaction costs and time value, but that Rowe's controlling interest was, in all respects, suitably marketable and liquid. Complicating the issue is Marietta's failure to offer into evidence any expert opinion as to the appropriate valuation

discount. Notwithstanding the fact that Southard's is the only expert opinion on valuation and that Southard opined that a 5% discount would not be, unreasonable, the Court rejects Southard's testimony on the issue. After a thorough review of the evidence elicited at trial and a review of respected sources on this issue, the Court finds it appropriate to employ a 10% discount to Rowe's 90% share of the $16,856,800 weighted valuation of ASC on the transaction date. See Pratt, Valuing A Business at 357; Fellows & Painter, Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome, 30 Stan. L. Rev. 895, 920-21 (1978). Thus, the Court finds that Rowe's 90% share of ASC was worth $13,654,008, as of March 17, 1989.

The next step in the "out of pocket" approach is to establish with some degree of certainty what Rowe received for his interest in ASC -- particularly, the true value of the transaction shares, had the fraud been known at the time of the transaction.

THE VALUE OF ROWE'S CONSIDERATION

Earlier, the Court found that Rowe believed, on March 17, 1989, that he had received $14,676,078 in return for his 90% interest in ASC. At the time, however, the fraud which would later rattle Marietta's stock prices had yet to become known -- to Rowe or to the market. Of

the five elements of payment for Rowe's interest in ASC, only the transaction shares were substantially influenced by the underlying fraud. The cash portions, $4,827,310 (unallocated) and $1,350,000 (non-compete), were paid in full at closing. The sum of cash consideration received by Rowe at closing was therefore $6,177,310. The present value of the note at closing was $1,884,716. The total earriout package, although it only generated $69,876 for Rowe, was contingent on ASC's earnings after the merger. Rowe presented no evidence that the failure of the earnout to generate $3,600,000 for Rowe was related to any fraud on the part of Marietta or Nadolski. Therefore, Rowe's right to the contingent eamout payments represents consideration received on March 17, 1989 in the amount of $3,600,000. The sum of consideration received by Rowe, on March 17, 1989, in the two cash components, in the note, and in the right to receive payments under the total earriout package, is $11,662,026. All that is left is the Marietta stock component of the acquisition price.

Rowe received 350,100 shares of Marietta common stock in the sale of ASC. These transaction shares were legended as unregistered and subject to the preemptive right of Marietta, diminishing their present value to Rowe as of March 17, 1989. On March 17, 1989, Marietta common stock traded at $13.25/share on the NASDAQ. Rowe, however, valued the restricted common stock at $8.61/share, for tax purposes. The Court notes that

Rowe's devaluation of the transaction shares from $13.25/share to $8.61/share reflects a 35% discount.[52]Further, the Court finds that a 35% illiquidity discount is appropriate to the circumstances.

Rowe asserts, though, that the transaction shares were really worth 65 % of a value much lower than the $13.25 market price of 3/17/89 -- a value, instead, that would have accurately reflected the market price of Marietta shares had the fraud and defalcations been revealed on or before March 17, 1989. Rowe produced expert testimony by Southard on the issue relating to this putative value.

Southard testified that the transaction shares were fraudulently inflated by at least $5.00/share, on March 17, 1989. To reach this figure, Southard established that the market would have valued Marietta stock at 10-12 times earnings. According to Southard, had true earnings in the first quarter of fiscal 1989 been reported immediately prior to the transaction, Marietta stock would have had a value of, at the most, $5.50/share, on a freely traded exchange. Assuming that the transaction shares would have traded on the high end of Southard's calculations, for the sake of conservatism, and applying a 35% illiquidity discount to

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[52]$13.25 x 0.65 (65 -/0) = $8.61.

the restricted transaction shares, the true value of the transaction, shares, as of March 17, 1989, would have been $3.58/share. Since Rowe received 350,100 of the transaction shares on March 17, 1989, the aggregate of consideration via the stock transfer component of the purchase price would be $1,253,358. If the Court were to add this final component to aggregate of the four other components of the purchase price listed above,[53] the total sum of consideration paid Rowe for his interest in ASC would be $12,915,384. Earlier, the Court found that Rowe's 90% share of ASC was worth $13,654,008 on March 17, 1989. Accordingly, under the plaintiffs hypothesis, the difference between what Rowe received and what he gave up would be $738,624.

Defendants urge the Court to reject Southard's valuation of the transaction shares at $3.58/share. Defendants argue that the correct adjustment is reflected in the market's reaction to Marietta's October 31, 1991 press release. Defendants insist that the amount of inflation in the transaction shares attributable to the fraud practiced upon both Rowe and the market is best measured by the amount by which Marietta stock fell on October 31, 1991 -- the day that Marietta released news that the company had "discovered evidence of possible defalcations of

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[53] In the aggregate, $11,662,026.

Company funds by a former financial officer aggregating at least $385,000 and of possible misstatements in the Company's financial statements for its 1988 and 1989 fiscal years." Upon public dissemination of this news, the market reacted by valuing Marietta stock at $5.125/share, down from $6.250/share on the previous day, a devaluation of $1.125/share, or 18%. Assuming that the total decrease was directly attributable to the announcement of possible embezzlement and financial misstatements, the defendants contend that this devaluation represents the market's absolute and total reaction to revelation of the fraud underlying this case. Applying the defendants' premise of a negative $1.125 market reaction to disclosure of the underlying fraud, and factoring in a 35% illiquidity discount based on the transaction shares' restrictions, the resultant value of Marietta stock, as of March 17, 1989, had the fraud been revealed at or before the closing date, would be $7.88/share.[54] By the defendants' calculations, Rowe's 350,100 transaction shares would have been worth at least $2,758,788 on March 17, 1989. Under this tack, Rowe would have received a total of $14,420,814 for his interest in ASC -- more than the $13,654,008 his share in the company was worth. If the Court were to accept the defendants' valuation of the transaction shares, then Rowe would be

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[54]($13.25/share - $1.125/share) x 0.65 = $7.88/share.

uninjured on the transaction and incapable of proving damages on the sale of ASC to Marietta.

The Court, however, has declined to follow either the plaintiffs or the defendants' approach, but, in the exercise of its sound discretion, to craft its own approach. Reves, 937 F.2d at 1336; Pelletier, 863 F.2d at 1558; Hackbart, 675 F.2d at 111; Arringlon, 651 F.2d at 621; Osofsky, 645 F.2d at 1121; Blackie, 524 F.2d at 909; Gottlieb, 452 F.2d at 516. Earlier, the Court found that 40% is the proper measure of inflation attributable to the defendants' fraud. On March 17, 1989, the price of Marietta common stock on the NASDAQ was $13.25/share. Assuming that the stock would have fallen 40% on March 17, 1989, if the fraud had been revealed on that day, then the true value of unrestricted Marietta stock would have been $7.95/share. Applying the 35% discount for the stocks restrictions, the Court finds that $5.17/share represents the value of the stock to Rowe, had the fraud been revealed on or before March 17, 1989. Rowe's 350,100 shares were, in the aggregate and in the absence of fraud, worth $1,809,142. Adding the unallocated cash, the non-compete cash, the note, and the rights under the total earnout package, the total consideration paid Rowe amounted to $13,471,168. In exchange, Rowe gave up the equivalent of $13,654,008. On March 17, 1989, the difference between what Rowe received and what he gave up was $182,840.

OFFSET DUE TO PROFITS ON DISPOSITION OF TRANSACTION SHARES

Application of the "out of pocket" recovery theory generally requires an offset to the plaintiff s damages of whatever profits may have accrued to the plaintiff in his disposition of the subject shares. Blackie, 524 F.2d at 908-09; Ballan, 159 F.R.D. at 483; In re Seagate, 843 F. Supp. at 1347-50; Katz, 117 F.R. D. at 407-08; Lev & de Villiers, Stock Price Crashes, 47 Stan. L. Rev. at 23-24. Rowe sold 175,000 of his 350,100 transaction shares between March 17, 1989 and August 1, 1990, prior to any market correction, for an average price of $23.99/share, and received approximately $4,200,000 on the sale of these 175,000 transaction shares. Rowe "purchased" these 175,000 shares for the equivalent of $8.61/share -- in the aggregate, $1,506,750. Rowe, therefore, passed on the inflation and is entitled to no recovery on these 175,000 transaction shares. Blackie, 524 F.2d at 908-09; Ballan, 159 F.R.D. at 483; In re Seagate, 843 F. Supp. at 1347-50; Katz, 117 F.R.D. at 407-08.

Between June 20 and October 3, 1991, Rowe sold another 100,100 transaction shares, for an average net price of $5.78/share. For these 100,100 transaction shares, Rowe received approximately $579,000. As the Court has already recognized, Marietta stock suffered a market correction attributable to the fraud, on August 14, 1990. In forced collateral sales on May 1 and May 12, 1992,

Rowe sold the remaining 75,000 transaction shares, for an average net price of $4.52/share. Rowe received approximately $340,000 on the disposition of the last 75,000 transaction shares.

On these 175, 100 transaction shares, Rowe is entitled to recover as damages the inflation attributable to the fraud, Blackie, 524 F.2d at 908-09; Ballan, 159 F.R.D. at 483; In re Seagate, 843 F. Supp. at 1347-50; Katz, 117 F.R.D. at 407-08, to the extent that he was actually damaged. 15 U.S.C. § 78bb(a); Randall, 478 U.S. at 663, 106 S. Ct. at 3153.

The Court finds that $603,344 represents the total, possible difference between what Rowe received and what he gave up, under the "out of pocket" method, as applied to the 175,100 transaction shares Rowe sold after the effects of the defendants' fraud reached the market. In reaching this figure, the Court subtracted the true value of the subject shares on the date of the acquisition -- $5.17/share -- from the $8.61/share valuation made in the absence of knowledge of the fraud, arriving at $3.44/share as the quantification of the inflation. The Court then multiplied the $3.44 factor by 175,100, producing the resultant $603,344. However, as earlier noted, Rowe's total damages on the acquisition were $182,840. Therefore, the Court utilizing its sound discretion to tailor the remedy to the plaintiff's harm, Reves, 937 F.2d at

1336; Pelletier, 863 F.2d at 1558; Hackbart, 675 F.2d at 111; Arrington, 651 F.2d at 621; Osofsky, 645 F.2d at 1121; Blackie, 524 F.2d at 909; Gottlieb, 452 F.2d at 516, and pursuant to 15 U.S.C. § 78bb(a) and respected interpretations thereon, limits Rowe's recovery on the disposition of the transaction shares to $182,840. Rowe's damages on the transaction are fixed at $182,840.

COMPUTATION OF DAMAGES ON THE OPEN MARKET SHARES

Of the 20,400 open market shares bought for an average price of $25.93 on July 31, 1989, Rowe sold 20,000 shares for an average price of $5.40/share and the remaining 400 shares at an average price of $4.07/share. In total, Rowe lost approximately $419,000 on the disposition of these 20,400 open market shares. Of the 450 open market shares purchased at an average price of $7.00/share on August 13, 1991, Rowe sold all 450 shares for $4.14/share.

Rowe lost $1,890 on this final disposition. Thus, Rowe lost approximately $421,000 on the open market transactions.

All of Rowe's open market purchases occurred prior to the express revelation of the defendants' fraud. All of Rowe's dispositions of the open market shares occurred after the market reacted to some element of the defendants'

fraud. Therefore, the Court awards Rowe damages in the amount of the inflation attributable to the fraud, on all of the open market shares.

The 20,400 open market shares purchased at $25.93/share, or $529,000, were really worth $15.56/share, or in the aggregate, $317,383. The 450 open market shares bought for $7.00/share, or $3,150, were really worth $4.20/share, or in the aggregate, $1,890. Rowe's total damages on the open market transactions are $212,877.

PUNITIVE DAMAGES AND PREJUDGMENT INTEREST

Although punitive damages are not permitted in private actions under § 10(b), See Stone, 8 F.3d at 1093; Grogan, 806 F.2d at 838, the award of punitive damages on pendant state fraud claims is allowed, provided that applicable state law permits such damages. Grogan, 806 F.2d at 838 (citing Nye, 588 F.2d at 1200; Ryan, 556 F.2d at 464; Falks, 504 F.2d at 706-07; Coffee, 474 F.2d at 1044; Young, 466 F.2d at 1337. Because Rowe's common law fraud claims arise under New York law, New York law is applicable to the question of punitive damages as well. See Gasperini v. Center for Humanities, Inc. , _____ U. S. _____, 116 S. Ct. 2211, 2221 n. 12 and 2224 (1996). Under New York law, punitive damages are intended to punish the wrongdoer and deter similar

conduct in the future. See Saint Calle v. Prudential Ins. Co. of America, 815 F. Supp. 679 (S.D.N.Y. 1993); Beir v. Manufacturers Hanover Trust Co., 488 N.Y.S.2d 1 (1st Dep't 1985).

During the years intervening the fraud in this case and the judgment of this Court, Marietta has come under new ownership and control and has corrected its filings with the SEC, a settlement has been reached between Marietta and a class of its outside shareholders, and the principal tortfeasors within Marietta have been punished criminally. Based on the foregoing, the totality of facts and circumstances in this case, and the applicable law, the Court finds that an award of punitive damages is neither necessary nor proper.

Federal law controls the question of whether to award prejudgment interest on Rowe's federal securities law claim. Blau v. Lehman, 368 U.S. 403, 414 (1962). The award of prejudgment interest is permitted on a successful § 10(b) claim and is within the sound discretion of the trial court. Grogan 806 F.2d at 838; Woods v. Barnett Bank, 765 F.2d 1004, 1014 (11th Cir. 1985)); De Vaughn 226 N.Y.S. at 476; Erbe, 151 N.Y.S.2d at 76. Under federal law, "the allowance of interest on damages is not an absolute right," City of Milwaukee v. Cement Div., Nat'l Gypsum Co., ____ U.S.___, 115 S. Ct. 2091, 2096 (1995) (quoting In re The Scotland, 118 U.S. 507,

518-19 (1886)); accord Wynn Oil Co. v. American Way Svc. Corp., 61 F.3d 904 (6th Cin 1995); Norte & Co. v. Huffins, 416 F.2d 1189, 1191 (2nd Cir. 1969), cert. denied, 397 U.S. 939 (1970); but see U.S. Indus., Inc. v. Touche Ross & Co., 854 F.2d 1223, 1256-57 (10th cir. 1988) ("[U]nder federal law, prejudgment interest is ordinarily awarded, absent some justification for withholding it."); cf. Huddleston, 640 F.2d 534; Wilson v. Great American Indus., Inc., 746 F. Supp. 251 (N.D.N.Y. 1990).

New York law determines whether prejudgment interest is appropriate to Rowe's commod law fraud claim. Bailey v. Chattem, Inc., 838 F.2d 149, 152 (6th Cir.) (whether to award prejudgment interest on substantive state law claim is governed by Klaxon, 313 U.S. 487), cert. denied, 486 U.S. 149 (1988); see also Strobl v. New York Mercantile Exch., 768 F.2d 22 (2nd Cir.), cert. denied, 474 U.S. 1006 (1984); Mallis v. Banker's Trust Co., 717 F.2d 683, 692 n. 13 (2nd Cir. 1983). Under New York law, prejudgment interest on a successful claim at law is mandatory, while prejudgment interest on a successful equitable claim is discretionary. N.Y.C.P.L.R. § 5001(a) (McKinney 1992); Indu Craft, Inc. v. Bank of Baroda, 87 F.3d 614, 617 (2nd Cir.), cert. denied, U.S. 117 S. Ct. 609 (1996); McCoy v. Goldberg, 810 F. Supp. 539, 546 (S.D.N.Y. 1993). Under New York law, the rate of prejudgment interest is statutorily fixed at 9% per

annum, and is computed from the earliest ascertainable date the cause of action existed, except that interest upon damages incurred thereafter are computed from the date incurred. N.Y.C.P.L.R. §§ 5001, 5004.

When a federal securities claim overlaps with a pendant state law claim, the plaintiff is entitled to the maximum amount recoverable under any claim. Groga, 806 F.2d at 839 (citing Jacobs, The Measure of Damages, 65 Geo. L. J. at 1166). In the case sub judice, the Court finds that prejudgment interest of 9% per annum is appropriate, under the plaintiff's pendant, common law fraud claim, and orders such interest exacted from the defendants on the following principal amounts and from the following dates:

1) 9% per annum on the principal amount of $182,840, from March 17, 1989;
2) 9% per annum on the principal amount of $210,987, from July 31, 1989; and,
3) 9% per annum on the principal amount of $1,890, from August 13, 1991.

CONCLUSION

The Court, pursuant to Rule 58 of the Federal Rules of Civil Procedure, as to both the federal and state law fraud claims, enters judgment against the defendants, Marietta Corporation and John Nadolski, jointly and

severally, in the total amount of $395,717, with prejudgment interest in accordance herewith. The Court expressly states that the total compensatory damage recovery, under either theory, or both, not including prejudgment interest, is limited in the aggregate to $395,717. The Court specifically decrees that the defendants be held jointly and severally liable for the entire amount of this judgment. The Court expressly recognizes the existence of an attorney's lien for fees and expenses in accordance with the agreement between the plaintiff and plaintiff's counsel. See Pl.'s Ex. 72.

The Court directs the Clerk of Court to enter a separate judgment pursuant to Rule 58 of the Federal Rules of Civil Procedure.

IT IS SO ORDERED, ADJUDGED AND DECREED this 6th day of June, 1997.

/s/ Bernice Bouie Donald
BERNICE BOUIE DONALD
UNITED STATES DISTRICT JUDGE

APPENDIX A

Period	Dates	Business Days In Period	High/Low	Average Price In Period	Difference From Prior Period	Percent Cumulative Average Price[1]	Cumulative Increase In Average Price[2]
1)	09/2O/88-10/17/88	20	11.250/11.000	11.08	N/A	N/A	N/A
2)	10/18/88-11/17/88	23	11.500/10.750	11.10	+00.2%	N/A	N/A
3)	11/18/88-12/19/88	21	11.250/10.750	11.04	-00.5%	N/A	N/A
4)	12120/88-01/17/89	19	12.000/10.750	11.26	+02.0%	N/A	N/A

[1]From first period after acquisition date of March 17, 1989.
[2]From acquisition date -- supra endnote 1.

5)	01/18/89-02/17/89	23	12.750/11.750	12.22	+08.5%	N/A	N/A
6)	02/21/89-03/17/89[3]	19	13.750/12.25	13.00	+06.4%	N/A	N/A
7)	03/20/89-04/17/89	20	15.750/13.375	14.38	+11.3%	14.38	+08.5
8)	04/18/89-05/17/89	22	20.750/16.000	18.49	+28.6%	16.53	+24.8
9)	05/18/89-06/19/89	22	21.250118.375	19.83	+07.2%	17.67	+33.4
10)	06/20/89-07/17/89	19	20.750/18.500	19.88	+00.3%	18.17	+37.1
11)	07/18/89-08/17/89	23	26.250t20,250	23.23	+16.9%	19.27	+45.4
12)	08/18/89-09/18/89	21	23.500/21.750	22.72	-02.2%	19.84	+49.7
13)	09/19/89-10/17/89	21	22.500119.375	21.29	-06.3%	20.05	+51.3
14)	10/18/89-11/17/89	23	21.750/19.500	20.48	-03.8%	20.11	+51.8
15)	11/20/89-12/18/89	20	23.500/21.250	22.54	+10.1%	20.36	+53
16)	12/19/89-01/17/90	20	25.750/22.250	23.96	+06.3%	20.70	+56.2

[3]Acquisition date: 3/17/89.

17)	01118/90-02/20/90	23	25.500/22.500	23.33	-02.8%	20.96	+58.2
18)	02/21/90-03119/90	19	24.750/22.750	23.66	+01.4%	21.16	+59.7
19)	03/20/90-04/17/90	20	25.750/24.250	23.99	+01.4%	21.44	+61.8
20)	04/18/90-05/17/90	22	25.750/22.500	24.37	+01.6%	21.65	+63.4
21)	05/18/90-06/18/90	21	26.250/24.000	25.36	+04.1%	21.90	+65.3
22)	06/19/90-07/17/90	20	26.750/24.750	25.33	-00.1%	22.10	+66.8
23a)	07/18/90-08/13/90[4]	19	27.250/22.875	25.66	+01.3%[5]	22.29	+68.2
23)	07/18/90-08/17/90	23	27.250/16.750	24.29	-04.1%	N/A	N/A
24)	08/2019-9/17/90	20	16.750112.875	14.32	-41.0%	NIA	N/A
25)	09/18/90-10/17/90	22	13.250/08.125	10.11	29.4%	N/A	N/A
26)	10/18/90-11/19/90	23	08.750/05.250	07.13	29.5%	N/A	N/A

[4]Abbreviated period.
[5]Abbreviated period

27)	11/20/90-12/17/90	19	06.500/05.000	05.80	18.7%	N/A	NIA
28)	12/18/90-01/17/91	21	07.500/05.000	06.42	+10.7%	N/A	N/A
29)	01/18/91-02/19/91	22	07.500/07.000	07.22	+12.5%	N/A	N/A
30)	02120/91-03/18/91	19	10.000/07.500	09.16	+26.9%	N/A	NIA

APPENDIX C

Order on Petition for Rehearing

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

DONALD M. ROWE,	)	FILED
	)	FEB 09 1999
Plaintiff-Appellant/Cross-Appellee	)	LEONARD
	)	
GREEN,Clerk		
V.	)	
	)	ORDER
MARIETTA CORPORATION; JOHN	)	
S. NADOLSKI,	)	
	)	
Defendants-Appellees/Cross-Appellants	)	

BEFORE: BOGGS, SUHRHEINRICH, and SILER, Circuit Judges

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and no judge of this court having requested a vote on the suggestion for rehearing en banc,

the petition for rehearing has been referred to the original panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

/s/ Leonard Green

Leonard Green, Clerk

APPENDIX D

Judgment of the District Court of The Western District of Tennessee

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IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TENNESSEE
WESTERN DIVISION

DONALD M. ROWE, J. DONALD ROWE, MASELLA B. ROWE, and CALIFORNIA SOAP CO., INC.,

Plaintiffs,

vs. No. 92-2963-D

MARIETTA CORPORATION and JOHN NADOLSKI,

FILED
JUNE 6, 1997

Defendants.

JUDGMENT

The Court, pursuant to Rule 58 of the Federal Rules of Civil Procedure, as to both the plaintiff's federal and state law fraud claims, enters judgment against the defendants, Marietta Corporation and John Nadolski, jointly and severally, in the total amount of $395,717, with prejudgment interest in accordance herewith:

1) 9% per annum on the principal amount of $182,840, from March 17, 1989;
2) 9% per annum on the principal amount of $210,987, from July 31, 1989; and,
3) 9% per annum on the principal amount of $1,890, from August 13, 1991.

The Court expressly states that the total compensatory damage recovery, under either theory, or both, not including prejudgment interest, is limited in the aggregate to $395,717, and specifically decrees that the defendants be held jointly and severally liable for the entire amount of this judgment. Plaintiff s demand for punitive damages on the state common law fraud claim is denied. With respect to the plaintiff's breach of contract claims, to the extent not abandoned prior to the trial, the Court finds in favor of the defendants. With respect to the plaintiffs state common law negligent misrepresentation claim, to the extent not dismissed in the Court's order of April 11, 1994 or abandoned prior to trial, the Court finds in favor of the defendants. The Court expressly recognizes the existence of

an attorney's lien for fees and expenses in accordance with the agreement between the plaintiff and plaintiffs counsel.

IT IS SO ORDERED, ADJUDGED AND DECREED this 6th day of June, 1997.

/s/_____

BERNICE BOUIE DONALD

UNITED STATES DISTRICT JUDGE

APPENDIX E

Statutes and Regulations Involved

15 U.S.C. §78j(b):

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

15 U.S.C. §78t(a):

> "Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and

to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

17 C.F.R. §240.10b-5:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

APPENDIX F

Other Material Petitioner Believes Essential to Understand the Petition

A note on Defendants' claim of waiver. Although neither the Sixth Circuit nor the District Court accepted Defendants' claim of waiver,[1] since it is mentioned in the Sixth Circuit decision, to avoid confusion an explanation and the record citations showing that there was no waiver are provided.

Rowe's Second Amended Complaint, paragraph 19, contained an allegation that Rowe had been fraudulently *induced* to agree to the terms of the earnout. (pp. 126a - 127a)). This claim, of course, was never waived and both the district court and the Sixth Circuit held that Rowe had proven fraudulent inducement. Rowe had also pled in the Second Amended Complaint, paragraph 21, that Marietta had committed a second and separate wrong (constituting both a fraud and a breach of contract) in the *execution* of the earnout clause by failing to report and pay the correct amounts (pp. 128a-130a).The contract terms required an audit as a prerequisite to a claim under that aspect of the case and further provided for resolution of any dispute

---

[1]Obviously, neither court would have reached the loss causation/earnout issue had they accepted the claim of waiver.

between the accountants by a "Big Eight" accounting firm (pp. 131a-133a). Because Rowe could not afford the expense of an audit that claim (fraud in the execution of the earnout) was dropped in opening statement. (pp. 135a). The same opening statement made it clear that Rowe was proceeding on the fraud in the inducement count. (pp. 135a-136a), as was again explained later in trial by co-counsel (pp. 137a-140a).

[Extract from the Second Amended Complaint]

THE EARN OUT AGREEMENT - EBIT

18. As additional consideration for the sale to Marietta of the shares pursuant to the Agreement, Marietta agreed to pay to the sellers fifty percent (50%) of the amount by which American Soap's Earnings, and Marietta's and American Soap' s soap business, Before Interest and Taxes ("EBIT") exceeded the EBIT threshold levels for the following years:

YEAR	THRESHOLD EBIT
1989 (7 months) -	1,653,167
1990 -	2,745,000
1991 -	2,856,000
1992 -	2,966,000
1993 -	2,888,000

During the fiscal year ending September 30, 1994, Marietta agreed to pay to the sellers 20.83 percent of the amount by which EBIT exceeded $2,900,000 during such year.

Fraud in the Inducement

19. A similar "Earn out" concept had been presented to Plaintiffs by Defendants in early 1987, when Defendants were then seeking to acquire American Soap. The approach of Defendants had been rejected in 1987 because the record

of Marietta did not show a sufficiently strong record to convince Sellers to turn the future of American Soap over to Defendant's management. However in the summer, fall and winter of 1988, Defendants returned to the negotiating table, re-proposed the Earn Out concept, and supported it with alleged records of good management and additional earnings growth. Those representations were intended to and did mislead Plaintiffs into believing that Marietta's management team had a more successful track record than was in fact true.

20. As set out more particularly hereinafter, Marietta misrepresented and falsified its actual 1987, 1988 earnings, and also its expected earnings for fiscal year 1989 (which began October 1, 1988), in the negotiations with the Plaintiffs. The public was also mislead by Defendants, misrepresentations, and as a result the value of Marietta's stock in the market had increased dramatically between the early 1987 approach and the Agreement of March 17, 1989. A material consideration to Plaintiffs under the Agreement was the alleged high quality of Marietta's management, which allegedly had honestly produced a dramatic increase in sales, earnings, and share values from 1987 to 1989. The entire agreement and the EBIT concept were and are tainted by fraud and misrepresentation.

Fraud in Implementation of the EBIT

21. Paragraph 1. 06 (e) of the Agreement contains a promise by Marietta that within 120 days after the end of each fiscal year ending September 30, 1989 through and including September 30, 1994, Coopers & Lybrand or such other firm of independent Certified Public Accountants as shall then be retained by buyer to examine its books of account, shall prepare and deliver to sellers a balance sheet as of the end of, and a statement of income or loss of Marietta for the period ending as of such date, together with a statement setting forth such accountants' calculation of the EBIT of the company. EBIT credits payable to Plaintiffs shall be calculated and paid in cash to Plaintiffs within 120 days after the end of each of buyer's fiscal years during which payments are due. EBIT credits shall bear interest for overdue amounts.

22. Under Marietta's control the EBIT calculations have not been made pursuant to generally accepted accounting principles, contrary to §1.06 of the Agreement.

23. Marietta also has failed to provide a meaningful good faith statement of such calculations and has failed to pay the amounts which should be due for EBIT credits. In addition to providing meager and deficient information, Marietta has taken positions and actions which were intended to prevent or reduce payments under the EBIT, and which constitute both a breach of terms of section 1.06(e) of the Agreement and of the covenant of good faith and fair dealing.

24. In bad faith Marietta has incurred unnecessary and unreasonable expenses, and has overstated expenses incurred, for purposes of the EBIT.

25. After Marietta assumed control of American Soap, the accounting functions critical to the allocations made by Marietta were shifted from American Soap (which has been prevented from maintaining meaningful separate books) to Marietta's home office in Cortland, New York, under the direct supervision of Blair, and Marietta terminated accounting personnel at American Soap and in its home office who were a potential threat to expose the accounting fraud being perpetrated by Marietta.

26. Marietta has refused to comply with requests for detailed information and explanation of its inadequate and deficient reports. These and other actions of Marietta have intentionally frustrated the mechanism set up under the Agreement for review of the figures by sellers, accountants.

27. On April 12, 1990, the Company announced that it had acquired two Canadian based companies involved in similar businesses as Marietta for a total acquisition price of $3.9 million. In violation of the terms of the Earn Out, sales of soap in Canada have never been included in the EBIT.

28. These, and other actions, have been intentionally taken by Marietta under the direction of the Defendant Nadolski and Blair, for the purpose of undermining and defeating the promised pay-out to sellers under the Earn Out provisions of the Agreement.

29. By letter to D. Rowe dated on or about April 11, 1990, Marietta indicated that the total for the first seven month payment (March 17, 1989-September 30, 1989 for the glycerine and EBIT Earn Outs was $70,887.00. Attached to Marietta's April 11, 1990 letter was a February 20, 1990 letter from Coopers & Lybrand stating that the figure was not based on an audit in accordance with generally accepted auditing standards and that material information may be lacking.

a) The EBIT reports provided to D. Rowe by Marietta on the dates set forth below for the years 1989-1992 have claimed that no payments were due under the Earn Out provisions:

Year	Date Rowe Received	EBITPaid
10/1/89 - 9/30/90	On or about May 5, 1992	- 0 -
10/1/90 - 9/30/91	" "	- 0 -
10/1/91 - 9/30/92	On or about March 17, 1993	- 0 -

b) The EBIT Report for the fiscal year 10/1/92 - 9/30/93 was due 1/30/94 and has not been provided by Marietta to D. Rowe. The EBIT report for 10/1/93 - 9/30/94 will be due on January 30, 1995.

[Extract from Stock & Asset Purchase Agreement (Between Rowe and Marietta) Dated March 10, 1989 (page 19):

(e) Within 120 days after the end of each fiscal year ending September 30, 1989 through and including September 30, 1994, Coopers & Lybrand, or such other firm of independent certified public accountants as shall then be retained by Buyer to examine its books of account, shall prepare and deliver to Buyer and Sellers a balance sheet as at the end of, and a statement of income or loss of Buyer for the period ended as of, such date. In addition, such accountants shall prepare and deliver to Buyer and Sellers a statement setting forth such accountants' calculation of the EBIT and Glycerine Credits of the Company. EBIT and Glycerine Credits payable to Sellers shall be calculated and paid, in cash, to Sellers within 120 days after the end of each of Buyer's fiscal years during which payments are due. EBIT and Glycerine Credits payable to Sellers shall not bear interest, except with respect to overdue amounts, as hereinafter provided.

At any time within three months after the furnishing of any such balance sheet or statement of income or loss to Sellers, Sellers may elect to question the accuracy of the statement by notifying Buyer to such effect. Sellers shall then have the right to employ together at their expense one firm of certified public accountants to examine the records and accounts of the Company in order to check the accuracy

of the questioned statements. Any statement not questioned by Sellers by notice during the said three month period shall be final and conclusive upon Sellers and shall constitute a final anc conclusive account stated. Regardless of any dispute Buyer shall pay or cause to be paid any amount of EBIT or Glycerine Credits no so disputed within the period such amounts would be payable if no dispute existed.

In the event that as a result of any examination of Buyer's books and records by the accounting firm employed by Sellers in accordance with the provisions hereof, errors in the statement transmitted by Buyer to Sellers hereunder for any fiscal period are determined in accordance with this paragraph and result in increased EBIT and Glycerine Credit payments to Sellers of more than $50,000 for such period, Buyer shall reimburse Sellers for the fees of such firm for conducting the examination with respect to such fiscal period. Buyer shall indicate any objection to the findings of the accounting firm retained by Sellers by a written objection given to Sellers within 30 days of the receipt of such findings. Within 15 days after the giving of such objection, the items in dispute shall promptly be submitted to the accountants of Buyer and Sellers for their joint resolution, and any such joint determination shall be binding upon the parties. if such accountants cannot resolve the items in dispute within 30 days after the submission of such items to them, the items in dispute shall be submitted to a firm of independent certified public accountants jointly

selected by the accountants for Buyer and Sellers (or by lot, if such accountants cannot agree on a selection) from among the so-called "Big Eight" accounting firms (other than any such firm that is then representing or has theretofore represented any party hereto), and the determination of the dispute by such form of accountants shall be final and binding on all the parties hereto. The fees and expenses of any such determination of such third accounting firm shall be borne 50% by Buyer and 50% by Sellers. If Buyer does not pay or cause to be paid any EBIT or Glycerine Credits to Sellers within the time periods specified herein, Buyer shall payor cause to be paid to Sellers interest on the overdue amounts from their due date to the date of payment at thereafter of twelve (12%) percent per anum.

If the Company shall be liquidated into or merged or consolidated with another corporation or shall transfer all or substantially all of its assets and business to another corporation, then the resulting entity shall assume all obligations to pay to Sellers their portion of Glycerine Credits and EBIT and shall agree to keep or cause to be kept separate accounting records with relation to the Soap Business theretofore conducted by the Company as if such Soap Business had been and continued to be conducted as a single entity. In such event, the terms "Glycerine Credits" and "EBIT" for any period subsequent to any of the aforesaid events shall mean the Glycerine Credits and EBIT of such Soap Business as shown on the pertinent statement

of income or loss prepared as provided herein. Upon any such liquidation, merger, consolidation or sale, Buyer and the Company shall not be relieved of their obligations to pay Glycerine Credits or EBIT to Sellers unless (i) the purchasing or surviving entity assumes said obligations and (ii) either (x) the net worth of the purchasing or surviving entity is at least equal to 150% of the net worth of buyer at the Closing Date, or (y) Rowe consents to the transaction involved. If, however, upon any such liquidation, merger, consolidation or sale, the condition set forth in clause (I) and either of the conditions set forth in clause (ii) are satisfied, then in such event Buyer and the Company shall automatically be relieved of and released from their obligations to pay Glycerine Credits or EBIT to Sellers.

[Extract from Plaintiff's Opening Statement, Trial Day 1]

Your Honor, we're -- another component that I had mentioned of the sale was the EBIT. And I will tell Your Honor that we are not seeking damages under the EBIT. The reason being that although we are not conceding that there was not fraud, there were not some shenanigans there, in fact there have not -- the discovery on that particular item to determine and reconstruct exactly what happened would be extremely expensive, and that is something that the plaintiff simply has not done, so we are not seeking damages under the EBIT, we are seeking damages just on the basis of what I have outlined to Your Honor.

And, Your Honor, Mr. Rowe will testify in this case as a witness in his own behalf and he will say had he known the truth, had he known the true financial figures of the Marietta Corporation, that the ones in the sales agreement were not as warranted.

There is no way in the world he ever would sold his company, he never would have signed the agreement.

And further had he known that the president of the Marietta Corporation and its treasure, Mr. Thomas Blair had been engaged in the pattern of fraud in supplying false numbers to the Securities and Exchange Commission

in the market place, he never would want to do with them and wouldn't have trusted them in the first place.

And, Your Honor, that will be the plaintiff's case and those are the damage that's we're seeking.

THE COURT: Thank you, Mr. Glenn.

[Extract from Trial Transcript, Statement of Plaintiff's Counsel Trial Day 1]

MR. MCQUISTON: Well, first of all, we do contend that the false representation affected the entire contract, including the earnout clause.

We do contend that the fraud vitiates the entire contract.

We also contend that the fact that they may have performed in good faith and done the best they could to perform the EBIT is no defense to the fraud claim.

We do contend that the contract as a whole included a number of different pay-out methods, but the contract as a whole was the subject of fraud (J. Appx. p. 488).

MR. MCQUISTON: Well, that Mr. Raines through a little clinker in there and that is why I was so long

answering. What he was saying was there -- he wanted us to stipulate that there is no causal connection between a failure of the earnout and the fraud, we do not agree -- we do not stipulate to that (Jt. Appx. p. 489).

[Extract from Trial Record Statement of Plaintiff's Counsel]

[Mr. McQuiston:] And we don't think that the evidence about the performance of the EBIT was material because we have nonsuited the contract claim.

The - - the difference here, Your Honor, is we're contending in this case that Mr. Rowe was fraudulently induced to enter into this contract. The contract includes the EBIT clause.

The EBIT clause starts on page 6 of the contract and goes for some 16 pages.

In the EBIT clause it says that Mr. Rowe has the right to challenge the EBIT, but the only way that he can do that is to employ certified public accountants to examine the records and accounts of the company. And that the statement must be challenged within three months of the report.

He did not do that, we admit that he did not do that.

We are not going to put on evidence in this courtroom of any kind of audit by any kind of accountants that the performance of the EBIT was defective. (Jt. Appx. pp. 766-7].

Supreme Court, U.S.
FILED
MAY 28 1999
CLERK

No. 98-1736

IN THE

Supreme Court of the United States

DAVID M. ROWE,

Petitioner,

v.

MARIETTA CORPORATION and JOHN S. NADOLSKI,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

Did the district court correctly apply the concept of loss causation to the facts of this securities fraud case?

STATEMENT PURSUANT TO RULE 29.6

Respondent Marietta Corporation is a wholly owned subsidiary of BFMA Holding Corp., which is privately held. Therefore, there are no publicly held companies that own 10% or more of Marietta Corporation's stock.

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STATEMENT OF THE CASE

In March 1989, Respondent Marietta Corporation purchased Petitioner Donald Rowe's 90% interest in American Soap, Inc., a soap manufacturing company (the "Purchase"). In exchange, Petitioner received, among other things, several million dollars in cash, a lucrative employment contract, restricted shares in Marietta Corporation and a right (referred to as the "Earnout") to a contractually determined percentage of the profits of Marietta Corporation, above certain thresholds, for the five years following the Purchase. At the time of the Purchase, Petitioner valued the Earnout at approximately $3,600,000. (Pet. App. 39a).

Economic circumstances caused a significant decline in the profitability of Marietta, and it was revealed in 1991 that Marietta had been fraudulently inflating its earnings for some period of time both preceding and following the Purchase. (Pet. App. 47a-49a). The value of Petitioner's shares fell, and Petitioner received $69,876 under the earnout. (Pet. App. 100a).

Petitioner brought suit in the United States District Court for the Western District of Tennessee, alleging, *inter alia*, breach of contract, common law fraud, securities fraud in violation of 15 U.S.C. § 78j and violation of the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961-64 (1984) (as amended). Several of the claims were dismissed before or during trial. The parties waived a jury, and a trial was held, followed by post-trial briefing. The district court made extensive findings of fact and conclusions of law, (Pet. App. 22a-116a), finding that Petitioner had established Respondents' liability for

common law fraud and securities fraud, and that Petitioner's remaining claims were without merit (Pet. App. 72a-73a & n.39). Applying the out-of-pocket method of calculating damages, the district court found that Petitioner's damages totaled $395,717, plus prejudgment interest. (Pet. App. 107a-108a, 111a-112a). In the course of calculating Petitioner's damages, the district court made a factual finding that "[Petitioner] presented no evidence that the failure of the earnout to generate $3,600,000 for [Petitioner] was related to any fraud on the part of [either defendant]." (Pet. App. 100a).

The principal argument on Petitioner's appeal was that the district court had erred in awarding him no damages in connection with the Earnout. The court of appeals, however, found no error in the district court's finding:

> Instead of bargaining for a sum certain, [Petitioner] accepted a risk that the merged corporation would meet the earnout thresholds. He must accept the value of the right to the earnout at the time of the transaction. Thus, in calculating out-of-pocket damages, $3.6 million was considered part of the "value of what he got." *There is no evidence that the fraud affected the merged corporation's ability to produce and profit. Market forces, not fraud, prevented Marietta from reaching the profit thresholds set in the earnout clause.*

(Pet. App. 12a-13a (emphasis added)). The court of appeals affirmed the judgment, and subsequently denied Petitioner's petition for rehearing and rehearing *en banc*. (Pet. App. 20a-21a).

REASONS FOR DENYING THE WRIT

Petitioner contends that the courts below misapplied the concept of "loss causation," and that their error is a symptom of deep confusion among the courts of appeals about that concept. Petitioner argues that the court of appeals erred by holding — allegedly in conflict with decisions of other Circuits — that loss causation was not established even though "securities fraud was committed by misrepresentations . . . *and the loss suffered was due to the materialization of the risk which was misrepresented.*" (Pet. i, 12 (emphasis added)). Petitioner's contention is wrong, however, because he mischaracterizes: (1) the findings of fact of the district court; (2) the holding of the court of appeals in this case; and (3) the holdings of the circuit courts with which the decision below is allegedly in conflict. Since the fact-specific decision of the trial court, which was affirmed below, does not conflict with any decision of this Court or of any court of appeals, further review is unwarranted.

I.

THE DISTRICT COURT FOUND THAT THE FAILURE OF THE EARNOUT WAS NOT PROXIMATELY CAUSED BY THE DEFENDANTS' FRAUD.

The district court found as a matter of fact that "[Petitioner] presented no evidence that the failure of the earnout to generate $3,600,000 for [Petitioner] was related to any fraud on the part of [either defendant]." (Pet. App. 100a). Petitioner never challenged that finding, and the court of appeals affirmed it. ("Market forces, not fraud, prevented Marietta from reaching the profit thresholds set out in the earnout clause.") (*See* Pet. App. 13a, quoted *supra*).

This factual finding mandates the conclusion of the court of appeals that "[Petitioner's] attempt to collect the earnout shortfall fails because the out-of-pocket measurement allows a plaintiff to recover only such losses as are proximately caused by the fraud." (Pet. App. 13a (citation omitted)). At bottom, Petitioner's disagreement with the court of appeals and the district court is a factual one: Petitioner contends that the failure of the Earnout to generate as much money as he had expected was proximately caused by the defendants' fraud, but the district court found "no evidence" in support of Petitioner's contention, and the court of appeals affirmed that factual finding.

Petitioner consistently misrepresents the record below, especially the district court's factual finding. For example, Petitioner states that his "loss resulted from the materialization of the same risk that was misrepresented," (Pet. 12), that "the investment risk misrepresented was the same risk that materialized," (Pet. 14), that "[the defendants' fraud] went to the heart of the earnout," (Pet. 16), and that "[Petitioner] proved that . . . the loss resulted from the materialization of that very risk" that was the subject of the defendants' fraud (Pet. 20). Each of these representations is refuted by the district court's finding of fact that "[Petitioner] presented no evidence that the failure of the earnout to generate $3,600,000 for [Petitioner] was related to any fraud on the part of [either defendant]." (Pet. App. 100a (quoted *supra*)). Petitioner never makes reference to that finding.

II.

PETITIONER MISREPRESENTS THE HOLDING OF THE COURT OF APPEALS.

Petitioner contends that the court of appeals misapplied the law, and therefore came into conflict with several other courts of appeals:

> The Sixth Circuit held that even though . . . [Petitioner's] loss resulted from the materialization of the same risk that was misrepresented, he failed to prove "loss causation." In so holding, the Sixth Circuit decision is in conflict with decisions of the Second, Fifth, Eighth, Ninth and Eleventh Circuits.

(Pet. 12). Neither the district court nor the court of appeals, however, barred Petitioner from recovering for loss that was proximately caused by the defendants' fraud. The district court found, and the court of appeals affirmed, that there was no evidence that the defendants' fraud was the proximate cause of Petitioner's Earnout-related loss. In other words, the court of appeals did *not* hold that "even though [Petitioner's] loss resulted from the materialization of the same risk that was misrepresented, he failed to prove 'loss causation.' " (Pet. 12). Rather, the court found exactly the opposite: Petitioner could not recover for his losses because the losses resulted from "[m]arket forces, not fraud." (Pet. App. 13a).

The court of appeals' analysis in this case was consistent with the holdings of all of the other circuit courts

of appeals: Loss causation is an element of a securities fraud claim.[1] Because Petitioner had not shown loss causation and the district court's valuation of the Earnout was not erroneous, the court of appeals affirmed the conclusion that Petitioner was not entitled to recover for the disappointing results of the Earnout. (Pet. App. 14a ("Because there is no evidence that the fraud was the proximate cause of Marietta's inability to earn beyond the thresholds, the district court's findings will not be disturbed.")

III.

PETITIONER MISREPRESENTS THE HOLDINGS OF OTHER COURTS OF APPEALS.

Petitioner further contends that cases from other circuits hold that where parties are in privity there is no need to prove loss causation. (*See* Pet. 12.) None of the cases that Petitioner cites stands for so broad a proposition. At least two of the cases he cites directly contradict the proposition. *See Bastian v. Petren Resources, Corp.*, 892 F.2d 680, 683-86 (7th Cir.) (privity between buyer and seller; *held*: plaintiff must establish loss causation), *cert. denied*, 496 U.S. 906

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1. *See, e.g., Weiss v. Wittcoff*, 966 F.2d 109, 111 (2d Cir. 1992); *Ketchum v. Green*, 557 F.2d 1022, 1029 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983); *Fryling v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 593 F.2d 736, 744 (6th Cir. 1979); *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 684-85 (7th Cir.), *cert. denied*, 496 U.S. 906 (1990); *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1327-28 (8th Cir. 1991), *aff'd on other grds.*, 507 U.S. 170 (1993); *McGonigle v. Combs*, 968 F.2d 810, 819 (9th Cir. 1992); *Bruschi v. Brown*, 876 F.2d 1526, 1530 (11th Cir. 1989).

(1990) (Pet. 14-15); *In re Letterman Bros. Energy Sec. Litig.*, 799 F.2d 967, 972-73 (5th Cir. 1986) (same), *cert. denied*, 480 U.S. 918 (1987) (Pet. 13).

All of the remaining cases cited by Petitioner either expressly require a finding of loss causation under Rule 10b-5 — *see Bruschi v. Brown*, 876 F.2d 1526 (11th Cir. 1989) (Pet. 13); *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616, 619 (8th Cir.), *cert. denied*, 502 U.S. 967 (1991) (Pet. 13) — or dispense with the requirement of loss causation because they apply the rescissory method of damage calculation, *see Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 772 n.4 (9th Cir. 1984) (Pet. 13); *Marbury Management Inc. v. Kohn*, 629 F.2d 705, 707 (2d Cir.), *cert denied*, 449 U.S. 1011 (1980) (Pet. 13); *Chasins v. Smith, Barney & Co. Inc.*, 438 F.2d 1167, 1173 (2d Cir. 1970) (Pet. 13, 22); *Garnatz v. Stifel, Nicholas & Co., Inc.* 559 F.2d 1357, 1360-61 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978) (Pet. 13, 17); *Harris v. Union Electric Co.*, 787 F.2d 355, 367-68 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986); *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1335-36 (8th Cir. 1991), *aff'd*, 507 U.S. 170 (1993) (Pet. 13).[2] By contrast, the district court in the instant case applied the out-of-pocket method of damage calculation.

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2. All but two of the cases cited by Petitioner that employed the rescissory method to calculate damages (*Harris* and *Arthur Young*) involved fraud by a fiduciary perpetrated against the purported beneficiary: Three of them involved customers suing their own brokers for churning or for recommending obviously inappropriate securities (*Hatrock*, *Brushi* and *Garnatz*); one involved a broker falsely representing that he was a licenced broker (*Marbury Management*); and one involved a broker's failure to reveal that his firm was the market maker in a security that the broker was recommending to the investors (*Chasins*). None of these cases involved falsified financial statements by a seller of securities at arm's length, as was the case here.

Although the rescissory method may be appropriate in some cases, *see Randall v. Loftsgaarden*, 478 U.S. 647, 662 (1986), the out-of-pocket method is the preferred method — *see, e.g.*, *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972); *Stone v. Kirk*, 8 F.3d 1079, 1082 (6th Cir. 1993); *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971) — and it was not error for the district court to apply it, particularly in the circumstance of this case. In any event, Petitioner has waived any claim that the use of the out-of-pocket method was error because Petitioner, on appeal, did not allege that it was error for the court not to use the rescissory method. (*See* Pet. App. 5a).

CONCLUSION

For the reasons given above, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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Supreme Court, U.S.
FILED
JUN 4 1999
CLERK

(4)

NO. 98-1736

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1999

DONALD M. ROWE,

Petitioner,

v.

MARIETTA CORPORATION, and
JOHN S. NADOLSKI,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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Vol. 2 at 545 (3d ed. 1995) 5

In Respondents' Brief In Opposition the Respondents, Marietta Corporation and John S. Nadolski, make three arguments not addressed in the Petition for Writ of Certiorari. This reply brief will explain why those arguments are fallacious.

I.

Respondents' first argument is that the district court found "as a matter of fact" that the failure of the earnout was not proximately caused by the Defendants' fraud. However, the conclusion of the district court was a conclusion of law, not fact. The Respondents make the following representation to this Court in their Brief in Opposition, page 3:

> "The district court found *as a matter of fact* that '[Petitioner] presented no evidence that the failure of the earnout to generate $3,600,000 for [Petitioner] was related to any fraud on the part of [either Defendant].' (Pet. App. 100a)" (Emphasis added.)

It is undisputed that Rowe presented evidence and the trial court found that Marietta had materially overstated its earnings record by falsifying its earnings growth in the three fiscal years immediately preceding the transaction with Rowe. Rowe proved that Marietta had grossly overstated both its sales and its profitability, and that in the quarter

immediately preceding the transaction, Marietta had concealed the fact that it had not been profitable, but had actually lost money. (See the portions of the Sixth Circuit decision at App. p. 3a and the district court's decision at App. p. 35a quoted in the Petition for Writ of Certiorari, pages 6 and 7).

The district court's conclusion that this proof was unrelated to the failure of the earnout to produce substantial increased profits was simply an incorrect legal conclusion, not, as represented by Marietta, a finding of fact. The earnout would produce no income for Rowe unless certain stipulated profit thresholds were exceeded. Those profit thresholds contained in the earnout required an *increase* over the allegedly existing (but fraudulently inflated) profits:

> "The [earnout's] structure, however, granted Rowe only a percentage of the profits above certain earnings thresholds, set higher for each succeeding year. When the merged corporation's earnings failed to meet that threshold, Rowe would receive nothing from the provision." (Sixth Circuit decision, App. 3a).

The district court's conclusion that the overstatement of existing profits was unrelated to the failure of the earnout to reach increased levels of profits was merely an erroneous

legal conclusion concerning "loss causation."[1] That it was only a conclusion of law is demonstrated by the application of a different legal test of causation to the facts found by the district court. For example, apply the legal standard for causation of the American Law Institute's Federal Securities Code to the facts found by the district court in this case:

> "A loss 'caused' by specified conduct to the extent that (A) the conduct was a substantial factor in producing the loss, and (B) the loss was of a kind that might reasonably have been expected to occur as a result of the conduct." 1 American L. Inst., *Federal Securities Code*, 56-63 (1980).

The fraud, of course, was the material misrepresentation of Marietta's profitability for the three fiscal years preceding the transaction. Since the true earnings of Marietta were lower than represented, the

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[1]The courts below apparently assumed that since "transaction causation" and "loss causation" must each be established, the same proof cannot establish both. That this is incorrect is demonstrated in Judge Posner's opinion in Bastian v. Petren Resources Corp, 892 F. 2d 680, 685-86 (7th Cir. 1990), in the portion quoted in Rowe's Petition for Writ of Certiorari, pp. 14-15. See also Village of Arlington Heights v. Poder, 712 F. Supp. 680, 685 (N.D. Ill. 1989) (in certain cases "transaction causation and loss causation merge").

likelihood that the earnout would fail to produce *increased* profits was obviously within the foreseeable risk of harm to Rowe which was produced by the fraud.

II.

For similar reasons, the second argument submitted in the Respondents' Brief in Opposition is also erroneous. In that section, Respondents argue (Brief In Opposition, p. 5):

> ". . . the court found [that] Petitioner could not recover for his losses because the losses resulted from '[m]arket forces, not fraud' (Pet. App. 13a)."

However, as the above quoted provision of the American Law Institute's *Federal Securities Code* demonstrates, when a different legal standard of loss causation is applied it becomes apparent that where, as here, the Defendants' misrepresentation was a substantial factor in inducing the Plaintiff to enter into the transaction, legal causation is not interrupted merely because other factors also contributed to the result. As the commentary (Comment 202(19)) to the American Law Institute's *Federal Securities Code* explains:

> "The language makes it plain, for example, that if the defendant' s misrepresentation was a 'substantial factor' in inducing the plaintiff

> to buy, the defendant is not absolved merely because other factors -- for example, the plaintiff's having received a large inheritance or his having been counseled to diversify his portfolio -- contributed to this result."

In this case the "other factors" that contributed to the result were "market factors." "Market factors" are commonly present in securities fraud cases since by their very nature such cases involve interests in businesses subject to market factors. The role of market factors, should be taken into account, not as a complete bar to recovery, but in the manner stated by Professor Hazen:

> "There is ample support for requiring that in a fraudulent inducement case, once the plaintiff establishes that there was transaction causation, the burden shifts to the defendant that the loss was due to wholly independent factors."Hazen, *Treatise On The Law of Securities Regulation*, Vol. 2 at 545 (3d ed. 1995).

III.

The third argument made by Respondents' Brief In Opposition is as follows (Brief in Opposition, p. 8):

> "Although the rescissory method may be appropriate in some cases, *see Randall v. Loftsgaarden*, 478 U.S. 647, 662 (1986), the out-of-pocket method is the preferred method -- *see, e.g., Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972); *Stone v. Kirk*, 8 f. 2d 1079, 1092 (6th Cir. 1993); *Levine v. Seilon, Inc.*, 439 F. 2d 328, 334 (2d Cir. 1971) -- and it was not error for the district court to apply it, particularly in the circumstance of this case. In any event, Petitioner has waived any claim that the use of the out-of-pocket method was error because Petitioner, on appeal, did not allege that it was error for the court not to use the rescissory method. (*See* Pet. App. 5a)."

This statement by the Respondents concerning an alleged waiver of the argument that the Randall v. Loftsgaarden method should be applied is incorrect. The case of Randall v. Loftsgaarden, 478 U.S. 647 (1986), as well as Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972) was argued in the Court of Appeals by Rowe. (See pages 43 and 44 of the Brief of Plaintiff/Appellant Donald M. Rowe in the United States Court of Appeals for the Sixth Circuit, and pages 26 and 27 of Donald M. Rowe's Reply Brief in the Sixth Circuit, now in Supplemental Appendix.) Randall v. Loftsgaarden, 478

U.S. 647 (1986) has also been relied on in the present Petition for Certiorari (page 11).

Ultimately, however, it matters not whether the rescissory method of damages of Randall v. Loftsgaarden, or the "out-of-pocket" measure is applied. Under either method, if correct legal standards are applied, Rowe would be returned to the *status quo ante*, i.e., he would recover the value he gave up as a result of the fraud.

Conclusion

Respondents' Brief in Opposition is based on the erroneous claim that the trial court's conclusions of law concerning causation were "findings of fact." The facts are not in dispute. All of the facts Rowe relies on in the Petition for Writ of Certiorari are direct quotes from the courts below. The law of loss causation was misapplied.

The Respondents' Brief in Opposition does not contest the fact that there is substantial confusion in the case law concerning the law of "loss causation." Nor does it contest the fact that over five hundred reported cases have applied the concept of loss causation in the securities fraud context. It does not contest the fact that the concept of loss causation is now in use in all circuits and that it is a consideration in every securities fraud case or controversy involving damages. It does not contest the fact that the Supreme Court has never spoken on the subject of this

important legal doctrine. It does not contest the fact that Defendants have profited by $3.7 million by committing the same fraud of which Defendant Nadolski was criminally convicted. It does not contest the fact that the innocent victim of that fraud lacks $3.7 million of being returned to the *status quo ante*.

Certiorari should be granted both to clarify the widely used concept of "loss causation" and to resolve the differences among the circuits.

Respectfully submitted,

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SUPPLEMENTAL APPENDIX

Pages 43 and 44 from "Brief of Plaintiff/Appellant Donald M. Rowe" in the United States Court of Appeals:

C. A Party Committing Fraud Must Be Required to Disgorge Those Benefits So As Not To Be Unduly Enriched

Regardless of the treatment of the other issues, it cannot be denied that, based on the district court's finding of the value of Rowe's interest in ASC, and the amount of money actually paid by Marietta, Marietta made a multi-million dollar profit from its fraud, in violation of the clear command of the U. S. Supreme Court. It is one of the firmest policies of the securities law that a party committing a fraud shall not benefit from that fraud. For this reason, the United States Supreme Court has directed that the out of pocket measure of damages should not be used when that rule would result in awarding a windfall to the wrongdoer. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155, 92 S. Ct. 1456, 31 L. Ed. 2d 741 (1972) states:

> "In our view, the correct measure of damages . . . is the difference between the fair value of all that the [plaintiff] received

> and the fair value of what he would have received had there been no fraudulent conduct, *except for the situation where the defendant received more than the [plaintiff's] actual loss. In the latter case damages are the amount of the defendant's profit.*" (emphasis added)

The trial court inadvertently awarded an enormous windfall profit to Marietta. As a result of the fraud, immediately after the March 17, 1989, transaction, Marietta received Mr. Rowe's interest in American Soap, which, according to the court's valuation, was worth $13,654,008. Yet Marietta paid to Mr. Rowe a total of only $9,935,654. Thus it received a profit from the fraud of at least $3,712,964, plus interest-free use of that money since March 17, 1989.

However, if the value of Mr. Rowe's interest in American Soap that was established by the transaction is used by the court (as it should be), we see that Marietta received value in the amount of $14,676,387, in exchange for payment to Mr. Rowe of $9,935,654. Thus, Marietta profited by its fraud in the amount of $4,740,733, plus interest-free use of that sum since March 17, 1989.

Though the trial court was apparently aware of the Affiliated Ute command that it must deviate from the out of

pocket measure of damages when necessary to prevent the fraudulent party from profiting from the fraud (see the reference to Affiliated Ute in the trial court's opinion at page 39), the trial court failed to follow the Supreme Court's clear and absolute directive in this regard, and was apparently unaware that the result of the judgment rendered was to award Marietta a multi-million dollar profit from the fraud.

New York law and federal securities law both require that the wrongdoer disgorge the profit from its fraud. The Supreme Court relied on New York law in Randall v. Loftsgaarden, 478 U.S. 647 at 663, 106 S. Ct. 3143, 92 L. Ed. 2d 525 (1986):

> "But the court in Affiliated Ute Citizens also indicated that 'where the defendant received more than the seller's actual loss . . . damages are the amount of the defendant's profit.' *Ibid.* This alternative standard aims at preventing the unjust enrichment of a fraudulent buyer, and it clearly does more than simply make the plaintiff whole for the economic loss proximately caused by the buyer's fraud. Indeed, the accepted rationale underlying this alternative is simply that '[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.' Janigan v.

> Taylor, 344 F. 2d 781, 786 (CA1), cert. denied, 382 U.S. 879, 86 S. Ct. 163, 15 L.Ed. 2d 120 (1965). *See also Falk v. Hoffman, 233 N.Y. 199, 135 N.E. 243 (1922) (Cardozo, J.).*" (emphasis added)

The referenced decision is by Judge Cardozo in the case of Falk v. Hoffman, 233 N.Y. 199, 135 N. E. 243 (1922). The Falk case involved a fraudulent transaction in stock, and held, applying New York law, that the wrongdoing defendants must account for and disgorge the proceeds and ensuing profits resulting from the fraud.

These holdings are, of course, in accordance with the universally recognized rule, as stated in the RESTATEMENT, RESTITUTION, §3: "A person is not permitted to profit by his own wrong at the expense of another."

Pages 26 and 27 from "Donald M. Rowe's Reply Brief" in the United States Court of Appeals:

Marietta has no rebuttal of the cases cited by Rowe establishing that both New York law and federal securities law require that the wrongdoer disgorge the profits from its fraud. This is the command of Randall v. Loftsgaarden, 478 U.S. 647, 106 S. Ct. 3143, 92 L. Ed. 2d 525 (1986), of Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155,92 S. Ct. 1456, 31 L.Ed. 2d 741(1972), and of Judge Cardozo's decision in Falk v. Hoffman, 233 N.Y. 199, 135 N.E. 243 (1922), as well that of the RESTATEMENT, RESTITUTION, §3: "A person is not permitted to profit by his own wrong at the expense of another."

Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155, 92 S. Ct. 1456, 31 L. Ed. 2d 741 (1972) states:

> "In our view, the correct measure of damages . . . is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct, *except for the situation where the defendant received more than the [plaintiff's] actual loss. In the latter case damages are*

the amount of the defendant's profit."
(emphasis added)

In other words, a defendant who has committed securities fraud cannot profit therefrom and must refund its profit to the victim of its fraud. Note that the Supreme Court did not say that damages "may" be the amount of profit. It states that the damages "are" that amount.

In Randall v. Loftsgaarden, 478 U.S. 647 at 663, 106 S. Ct. 3143, 92 L. Ed. 2d 525 (1986) the Supreme Court stated:

> "But the court in Affiliated Ute Citizens also indicated that 'where the defendant received more than the seller's actual loss . . . damages are the amount of the defendant's profit.' *Ibid.* This alternative standard aims at preventing the unjust enrichment of a fraudulent buyer, and it clearly does more than simply make the plaintiff whole for the economic loss proximately caused by the buyer's fraud. Indeed, the accepted rationale underlying this alternative is simply that '[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.' Janigan v. Taylor, 344 F. 2d 781, 786 (CA1), cert.

denied, 382 U.S. 879, 86 S. Ct. 163, 15 L.Ed. 2d 120 (1965). *See also Falk v. Hoffman, 233 N.Y. 199, 135 N.E. 243 (1922) (Cardozo, J.).*" (emphasis added)